Executive Compensation Alert

IRS Issues Final Regulations Under Section 409A

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OVERVIEW

On April 10, 2007, the IRS issued final regulations under Section 409A of the Internal Revenue Code of 1986, as amended (Section 409A). The final regulations will be effective January 1, 2008. Up to December 31, 2007, taxpayers may continue to rely on the current standard of good faith compliance under Section 409A, the proposed regulations, the final regulations and other guidance issued under Section 409A.

BACKGROUND

Section 409A provides that if certain requirements on the timing of distributions are not met, then all amounts deferred under a nonqualified deferred compensation plan are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in income or vested prior to December 31, 2004. In addition to the taxpayer having to pay regular income and employment taxes on the includible amount, Section 409A imposes a 20%+ tax on the income deemed to have been received, even if it is still beyond the taxpayer's reach. Some states, including California, have tax structures similar to those of Section 409A.

KEY REQUIREMENTS OF SECTION 409A

Highlights of the Final Regulations under Section 409A Applicable to Technology Companies

- **Stock Options and Stock Appreciation Rights (SARs)**
  Stock Options and SARs issued with an exercise price at least equal to fair market value on the date of grant are generally exempt from Section 409A. The final regulations address the following issues:

  - Any reasonable application of a reasonable valuation method can be used for this determination, but the final regulations provide certain safe-harbor methods.

  - The IRS has effectively left unchanged the "safe harbor" for an independent third-party appraiser. This will continue to be the most viable alternative for private technology companies. However, for early stage start-up companies, the final regulations make the "*illiquid start-up*" safe-harbor more viable by providing:

    - (i) that the valuation determination can be made by any person, whether inside or outside the company, with "significant knowledge, experience, education, or training", where a reasonable individual would reasonably rely on such valuation advice. The phrase "*significant knowledge, experience, education or training*" generally will mean "at least five years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry" of the company;

    - (ii) that no change in control may reasonably be expected to occur within 90 days after the valuation and that no IPO may reasonably be expected to occur within 180 days after the valuation. This is a favorable change in that the proposed regulations had set the period at one year. Boards of directors of early stage start-up companies may still be reluctant to use this *illiquid start-up* safe-harbor, but it is now a realistic alternative to an independent third-party appraiser, especially for an early stage company.

  - The final regulations significantly broaden the types of common stock that can be used for the award of stock options and SARs exempt from Section 409A if issued at no less than fair market value. Under the final regulations, any class of common stock of a "*service recipient*" corporation can be made subject to the award if it does not carry preferential rights other than on liquidation of the issuer. This stock is referred to as "service recipient stock". Moreover, the underlying shares can be either of (i) the corporation in direct receipt of the individual's services, or (ii) any other corporation that such corporation controls, or is controlled by (meaning there is at least 50% ownership throughout the chain of relationship). (If there are "legitimate business criteria" (an undefined term) to justify the grant, the minimum ownership throughout the chain of relationship need be no more than 20%.) The final regulations no longer provide that if there is a parent public company, then that public company's shares must be used for the award of stock options and SARs in order for such awards to be exempt from Section 409A.

- The post-termination exercise period of an option or SAR may be extended to the shorter of (i) its original maximum term, or (ii) 10 years from its original date of grant. Further, stock options and SARs that were granted prior to April 10, 2007, may be extended without limitation. Finally, if the stock options were ISOs that were disqualified by the extension, the above rules apply for determining whether the extension causes a new Section 409A problem. Of course, if options are unexercisable due to applicable securities laws then the options still can be modified to remain outstanding for as long as 30 days from the date exercise again becomes permissible under applicable securities laws. These are very favorable changes that are "well received." Companies that previously granted options that were not in compliance with the more restrictive proposed regulations can now rely on these final regulations and can now take the position that Section 409A was not violated by prior extensions.

- **Severance Arrangements**

  - The final regulations continue to provide that Section 409A will not apply when severance payments are completed by March 15 of the year following the year in which the vesting of severance occurs (in other words, an *involuntary termination* from service). Thus, severance payments that will be made to a "specified employee" within this timeframe need not be delayed by six months.

  - Section 409A will not apply to severance payments due to an *involuntary termination*, so long as the aggregate amount does not exceed an annually-adjusted figure ($450,000 for 2007) and all payments are completed by the second anniversary of the date of termination.

  - The final regulations provide that Section 409A will not apply if the taxpayer can prove there was a "*constructive termination*" (in other words, "*a good reason termination*") by the employer. Such a constructive termination will be deemed to constitute an *involuntary termination*. The final regulations provide a safe harbor from treating separation payments made in respect of such an *involuntary termination* as subject to Section 409A if: (i) the termination is due to a material diminution in base compensation, authority, duties, responsibilities or reporting, (ii) the voluntary termination occurs within 2 years after such change first occurs, (iii) the employee is required to notify the employer within 90 days of such change occurring, (iv) the employer is provided at least 30 days in which to remedy the change, and (v) the amount, time and form of the severance paid is no different from that paid on an *involuntary termination* without cause. The proposed regulations had provided that severance payments due to a constructive termination would be subject to Section 409A.

  - A Section 280G tax gross-up will avoid the six month waiting period if paid by the end of the calendar year in which payments are made by an executive to the IRS. This is a very practical and good change from the proposed regulations.

  - The final regulations make clear that employees of a private company that are terminated soon after an acquisition by a public company, will not be treated as specified employees subject to the six month delay in payment rules.

METHOD FOR CALCULATING AND REPORTING INCOME SUBJECT TO SECTION 409A TAX STILL UNCERTAIN

The final regulations do not contain guidance on the calculation of amounts required to be included in income upon a violation of Section 409A. A good faith effort will need to be made to achieve compliance in light of existing guidance (presumably California taxpayers will be able to rely on this good faith standard in the event of a challenge from California's Franchise Tax Board). In addition, withholding and reporting is not addressed in these final regulations and therefore, reliance remains on the guidance provided in IRS Notice 2006-100 and Notice 2005-1.

ACTION ITEMS

All equity-based compensation arrangements, severance arrangements and nonqualified deferred compensation plans that extend beyond December 31, 2007, should be reviewed for compliance with the final regulations. Where necessary to bring into compliance with the final regulations, these arrangements and plans should be revised (or further revised if previously amended in light of the proposed regulations such that they will extend beyond December 31, 2007) no later than December 31, 2007.

At an April 12, 2007, presentation to members of the National Association of Stock Plan Professionals, representatives of the IRS expressed their opinion that inclusion in a plan of a statement that the plan is to be administered in compliance with Section 409A would not itself be effective to imply the inclusion of provisions that are required by Section 409A and the regulations, nor would it be effective to negate the presumption that provisions that clearly contradict the requirements of Section 409A and the regulations are effective.

For more information on this, or related matters, please contact any attorney in the Equity Compensation and Employee Benefits Group below.

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