

Proposed 409A Regulations: Equity Compensation Arrangements

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Insight — 10/18/2005 12:00:00 AM

On October 4, 2005, the IRS issued long-awaited proposed regulations under Section 409A regarding the treatment of nonqualified deferred compensation plans. This alert focuses on the portion of the guidance that offers significant detail on the treatment of equity-based compensation, including the treatment of stock options, stock appreciation rights ("SARs") and other forms of deferred compensation linked to equity performance.

This is the second in a series of four alerts that the Benefits Law Group of Holland & Hart LLP will issue to cover different features of the proposed regulations in more detail. This series of Alerts assumes a general familiarity with Code Section 409A, so if you would like to refresh your knowledge in this area, please review our previous Benefits Alerts for background information on this topic.

Equity Compensation Arrangements

In general, stock options, SARs and other equity-based compensation arrangements ("Stock Rights") are subject to the provisions of Section 409A unless certain exceptions are met. Fortunately, the proposed regulations incorporate the key exceptions initially set forth in Notice 2005-1, and new exceptions have been added.

However, the preamble states that the IRS and Treasury remain concerned that manipulation of stock valuations and the characteristics of stock underlying these Stock Rights leave this an area of potential abuse. As a result, the new guidance also contains highly detailed provisions addressing dividend rights on option and SAR exercise, permissible valuation methods, and the type of stock that may be made subject to equity-based awards that will be exempt from Section 409A. Thus, although employers have reason to be optimistic regarding the liberalization of the rules from earlier guidance, caution in several areas is still warranted.

Stock Options

The legislative history and Notice 2005-1 state that Section 409A does not apply to the grant of stock options at full fair market value, provided that the option has no additional deferral features. Options exempted may be options to acquire the stock of the employer or another "service recipient." This broad exception has been retained in the proposed regulations.

Conversely, the regulations confirm that Section 409A restrictions *do* apply to discounted stock options. Unfortunately, however, the proposed regulations do not offer practical examples regarding how to apply the election and distribution restrictions to discounted stock options.

Stock Appreciation Rights

The regulations offer a significant expansion from the earlier guidance in Notice 2005-1 that excepted from Section 409A only stock-settled SARs of a publicly traded company. The proposed regulations provide an exclusion from 409A coverage for both private company SARs and cash-settled SARs, provided that the SARs essentially mimic the option exception: that is, to qualify for the exception to 409A, the SARs must be issued at full fair market value with no opportunity for additional deferral, and the amount payable on exercise of the SAR cannot exceed the difference between the fair market value of the stock on the date of exercise of the SAR and the fair market value of the stock on the date of grant of the SAR.

Dividend Rights

Under the proposed regulations, the right to receive, upon exercise of an option or a SAR, dividends previously declared and paid on the shares subject to the option or SAR will be deemed to be an "offset" against the exercise price. As such, this likely will cause the option to fail to satisfy the requirement that the optionee pay the full fair market value for the option at the date of grant. Although the regulations specify that a separate right to receive dividend payments will not constitute an offset, this separate arrangement in itself may give rise to deferred compensation subject to Section 409A, which means that the timing and form of payment requirements would have to be met for this portion of compensation.

Effect of Modification of a Stock Right

If an option or SAR is modified, the date of modification will be a new grant date on which the award must be measured against the then-current fair market value of the underlying stock. Failure to price the option or SAR at the updated fair market value may subject the award to the Section 409A requirements, if the award would be considered at less than full fair market value as of the date of the modification. The proposed regulations describe the circumstances under which a Stock Right will be considered modified (and therefore require a reevaluation of the fair market value) as follows: a modification is any change in the terms of the option that may provide the holder with a direct or indirect reduction in the exercise price; an additional deferral feature; or an extension or renewal of the option. Fortunately, there are two notable exceptions to this general rule: first, there is no modification where the optionee's exercise period is extended to the *later* of (i) the last day of the calendar year in which the option would otherwise have expired; or (ii) 2½ months after the date the option would have expired; and second, there is no modification where only the vesting of the option is accelerated.

Valuation of Stock Underlying Awards

Notice 2005-1 provided without explanation that in determining whether stock awards were granted at full value, any "reasonable" valuation method was permitted. In contrast, the proposed regulations offer several specific valuation methods, depending upon the nature of the corporation.

- *Publicly Traded Companies.* The regulations establish a permissible range of dates that may be used to establish the stock's fair market value. In general, the last sale prior to grant, first sale after grant, closing price on trading day before or of the grant, and an average of the stock price over a range of 30 days before or after the grant date (so long as that period is established prior to the grant) are all acceptable.
- *Privately Held Companies.* The regulations provide a description of the factors and presumptions that will be applied in evaluating whether a valuation is reasonable. In general, the factors examined include the value of the corporation's assets, the present value of future cash-flows of the corporation, the market value of stock or equity interests of similar companies engaged in similar trades or businesses, control premiums, discounts for lack of marketability and whether the valuation method is used for other purposes that have a material economic effect on the company. "Safe harbor" presumptions of reasonableness include an independent appraisal within 12 months or use of a formula if also used for non-compensatory reasons. Any valuation older than 12 months or that ignores information that has changed since an earlier valuation is presumptively not reasonable.
- *"Start Up" Companies.* The regulations also provide an explanation of the conditions under which the valuation of the illiquid stock of the start-up will be presumed reasonable. These standards are less rigorous than those applied to other privately held companies. In general, a "start up" is a company that has been conducting business for fewer than 10 years, has no class of securities traded on an established market, and does not anticipate either a change in control or an initial public offering within 12 months following the date the valuation is applied.

Definition of "Service Recipient Stock"

For purposes of determining individuals that may receive Stock Rights, the proposed regulations provide a more expansive definition of the "service recipient" than initially outlined in Notice 2005-1. Rather than limiting the definition of a "service recipient" to a "controlled group" of corporations requiring an overlapping ownership interest of at least 80%, a corporation will be considered a service recipient if the threshold of common ownership is 50%. In addition, if two corporations are members of a joint venture, then only 20% common ownership is required, provided that there is a legitimate business purpose for granting the stock of the related corporation. As a specific example, the regulations permit awards to be granted to employees of the joint venture with this lower threshold of

ownership if the grantees of the award are former employees of the granting corporation.

Performance-Based Compensation

The regulations provide that in the case of "performance-based compensation" based on service performed over a period of at least 12 months, a deferral election may be made up to 6 months before the end of the service period. "Performance-based compensation" means compensation for which the amount of, or entitlement to, the compensation is contingent on the satisfaction of preestablished organizational or individual performance criteria relating to a period of at least 12 consecutive months. "Performance-based compensation" does not include any amount that will be paid regardless of performance, or based on a level of performance that is substantially certain to be met at the time the criteria are established.

Performance criteria will be considered preestablished if they are established in writing no later than 90 days after the commencement of the performance period. It is not required that the performance criteria be approved by a compensation committee of the board of directors in order for payments based on the criteria to qualify as performance-based. The regulations also require that the participant perform services continuously from no later than the date the performance criteria are established through the date of the deferral election.

Performance criteria may be subjective in nature, provided the criteria relate to the participant or a group or business unit to which the participant provides services, and the determination of whether the criteria have been satisfied is not made by a person who is under the supervision or compensation authority of the participant.

Compensation may also be performance-based if it is based solely on the increase in the value of the service recipient, or its stock, after the date of grant of the award (as in a stock option or SAR). If the amount of compensation that the participant will receive is not based solely on appreciation after the date of grant, however (as in a restricted stock unit or discounted SAR), and such amount would not otherwise qualify as performance-based compensation, the compensation attributable to the grant will not qualify as performance-based compensation. By contrast, an award of equity-based compensation may qualify as performance-based if the compensation is subject to a condition that would otherwise render it performance-based, such as a performance-based vesting condition.

Other Equity-Based Compensation

- *Restricted Stock.* The issuance of restricted stock is not subject to Section 409A, whether or not the participant makes a Code Section 83(b) election with respect to the restricted stock.
- *Restricted Stock Units ("RSUs").* RSUs that entitle the participant to receive stock following the satisfaction of

specified service or vesting conditions will not be subject to Section 409A if the stock will be issued in compliance with the short-term deferral exception (either upon vesting or within 2½ months following the close of the year in which vesting occurs). If issuance of the stock is to be made after the short-term deferral period, then the arrangement constitutes a deferral of compensation that must be structured to comply with Section 409A.

RSUs that provide for the issuance of vested shares within the short-term deferral period can be structured to allow the recipient to defer the issuance of those shares beyond the short-term deferral period, provided that the initial vesting of the award does not occur for at least 13 months following the award date, and the participant makes a deferral election (as to the time and form of payment) within 30 days after the award date.

- *Phantom Stock.* Phantom stock will be subject to Section 409A. If phantom stock vesting is based on the satisfaction of performance criteria, however, qualifying the phantom stock for treatment as performance-based compensation, the participant may make an initial deferral election at any time prior to the last 6 months of the performance measurement period.
- *Earn-Outs.* Compensation payable with respect to the purchase of service recipient stock or stock rights in a change in control will be treated as paid at a specified time or pursuant to a fixed schedule in compliance with Section 409A distribution requirements, provided that, first, the compensation is paid on the same schedule and in accordance with the same terms and conditions as payments are to be made to stockholders in an acquisition of stock or to the corporation in an acquisition of its assets, and second, the payments are made within 5 years of the change in control event. This broad rule should permit the proper structuring of earn-out arrangements and indemnity escrows for compliance with Section 409A.

Note that the proposed regulations generally incorporate the change in control provisions from Notice 2005-1, which pertain only to corporations. The Treasury and the IRS intend to issue regulations extending these rules to partnerships, and until then, the existing rules for corporations may be applied by analogy to partnerships. Relief has not been provided for other non-corporate entities, but Treasury and IRS have requested comments in this regard.

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