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## Equity Compensation under the Final 409A Regulations

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### Overview

The IRS recently issued final regulations under Section 409A of the Internal Revenue Code (the Code) related to nonqualified deferred compensation. While the final regulations generally retain the approach taken by the IRS in the proposed Section 409A regulations, the final rules are more generous and include greater flexibility with respect to equity compensation arrangements. In particular, and as explained in more detail below, the final regulations:

- do not change the types of awards that are, and are not, subject to Section 409A;
- permit the exercise period of a stock option or stock appreciation right (stock rights) to be extended to the earlier of the expiration date of the stock right or 10 years from grant, and permit unlimited extensions of the exercise period of underwater stock rights;
- provide greater flexibility with respect to valuations of private company stock; and
- expand the definition of service recipient stock both as to the classes of stock covered and the issuing entities.

This alert summarizes the rules set forth in the final regulations with respect to equity compensation, and provides our recommendations for bringing your arrangements into compliance with the new rules.

### Background

The American Jobs Creation Act of 2004 (the Act) added Section 409A to the Code, which provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in income, unless strict timing and documentary requirements are satisfied. Among the Section 409A requirements is a six-month delay for separation payments made to specified employees of publicly traded companies. A violation of Section 409A results in the assessment of a 20% penalty tax and interest on the employee or service provider, in addition to regular income and employment taxes.

The final regulations are scheduled to become effective on January 1, 2008, by which date all nonqualified deferred compensation arrangements must be in documentary compliance with the

final regulations. Until that date, all such arrangements must be operated in good faith compliance with the final regulations, the proposed regulations or other guidance issued under Section 409A.

#### **Awards Exempt from, and Subject to, Section 409A**

The final regulations generally do not change the types of equity compensation arrangements that are exempt from, and those that are subject to, Section 409A. In particular, the following are:

**Exempt from Section 409A:** incentive stock options; Section 423-compliant employee stock purchase plans; nonqualified stock options and stock appreciation rights that have an exercise price at least equal to the fair market value of the service recipient stock on the date of grant, and that do not otherwise have a deferral feature; restricted stock; and restricted stock units provided that the shares are delivered upon vesting.

**Subject to Section 409A:** nonqualified stock options and stock appreciation rights that have a less than fair market value exercise price, that are not issued on service recipient stock or that otherwise contain a deferral feature; and restricted stock units or deferred stock units under which the shares are not delivered upon vesting.

#### **Extensions of Stock Right Exercise Period**

The final regulations provide significantly more flexibility to extend the exercise period of a stock right without the option becoming subject to Section 409A. Under the final regulations, the exercise period of a stock right may be extended to the earlier of (i) the original term of the stock right and (ii) 10 years. If the extension exceeds the permitted period, the stock right will be treated as if it had a deferral feature from the original date of grant of the right. As a result, the right will likely become subject to Section 409A retroactive to the original date of grant. The final regulations also provide that there is no limitation on the ability to extend the exercise period for a stock right that has an exercise or base price that is in excess of the current fair market value of the company's stock (e.g., an underwater right).

#### **Determination of Fair Market Value of Private Company Stock**

As stated above, in order for stock rights to be exempt from Section 409A, among other things, the right must have an exercise price that is at least equal to the fair market value of the company's stock on the date of grant of the right. The final regulations retain the general standard that a valuation based on a reasonable application of a reasonable valuation methodology is required. The final regulations further state that among the factors to be considered in a reasonable methodology are the value of tangible and intangible assets, discounted cash flows, the value of equity interests in comparable companies, recent arm's length transactions in the stock, and other relevant factors, such as control premiums and discounts for lack of marketability. Consistent use of a valuation method is also supportive of its reasonableness, but is not required.

The new rules also retain the safe harbors for valuing private company stock that were contained in the proposed Section 409A regulations, but with added clarifications and flexibility. To that end, the use of either of the following methods is presumed to result in a reasonable valuation:

- a valuation by a qualified independent appraiser as of a date that is no more than 12 months before the date the valuation is applied (e.g., the date of grant of a stock right); and
- a valuation, made reasonably and in good faith and evidenced by a written report, of illiquid stock of a startup company (a company that has been in business for less than 10 years). This safe harbor is not available if the company reasonably anticipates, at the time the valuation is applied, that it will undergo a change in control within 90 days or will have a public offering within 180 days. Moreover, this safe harbor is not available unless the valuation is performed by a person or persons that the company reasonably determines is qualified to perform such a valuation based on his or her significant knowledge, experience, education or training (generally, at least five years of experience in a relevant field).

### **Service Recipient Stock**

In addition to being granted with a fair market value exercise price, stock rights must be granted with respect to “service recipient stock” in order to be exempt from Section 409A. The final regulations expand the definition of service recipient stock to include any class of common stock within the meaning of Section 305 of the Code, which includes common stock with liquidation preferences. In addition, the final regulations provide that service recipient stock may include stock of the direct service recipient, as well as that of any corporation in a chain of entities that have a controlling interest in the direct service recipient. As a result, “stock of the service recipient” is not necessarily limited to the stock of the common parent of a controlled group. Rather, stock of a direct or indirect subsidiary, or of any corporations up the chain to the common parent, can be treated as service recipient stock with respect to service providers of such subsidiary. However, stock of a subsidiary that is below the corporation for which the service provider performs services will not be treated as service recipient stock.

### **Our Recommendations**

Clients should begin a review of their equity compensation awards to determine which awards are exempt from, and which are subject to, Section 409A. Any awards that are subject to Section 409A must be brought into documentary compliance with the statute and final regulations by January 1, 2008. In addition, clients should review their procedures for granting equity awards to ensure that future grants are properly structured to be exempt from, or compliant with, Section 409A.

For more information on this or other tax matters, please see our prior [tax publications](#), or contact:

[A. William Caporizzo](#)

+1 617 526 6411

[william.caporizzo@wilmerhale.com](mailto:william.caporizzo@wilmerhale.com)

[R. Scott Kilgore](#)

+1 202 663 6116

[scott.kilgore@wilmerhale.com](mailto:scott.kilgore@wilmerhale.com)

[Amy A. Null](#)

+1 617 526 6541  
[amy.null@wilmerhale.com](mailto:amy.null@wilmerhale.com)

William H. Schmidt  
+1 617 526 6946  
[bill.schmidt@wilmerhale.com](mailto:bill.schmidt@wilmerhale.com)

Linda K. Sherman  
+1 617 562 6712  
[linda.sherman@wilmerhale.com](mailto:linda.sherman@wilmerhale.com)

Kimberly B. Wethly  
+1 617 526 6481  
[kimberly.wethly@wilmerhale.com](mailto:kimberly.wethly@wilmerhale.com)

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## *Authors*



**A. William  
Caporizzo**

**PARTNER**

Vice Chair, Transactional  
Department

✉ [william.caporizzo@wilmerhale.com](mailto:william.caporizzo@wilmerhale.com)

☎ +1 617 526 6411



**R. Scott Kilgore**

**PARTNER**

✉ [scott.kilgore@wilmerhale.com](mailto:scott.kilgore@wilmerhale.com)

☎ +1 202 663 6116



**Amy A. Null**

**PARTNER**

✉ [amy.null@wilmerhale.com](mailto:amy.null@wilmerhale.com)

☎ +1 617 526 6541

**Linda K. Sherman**

**RETIRED PARTNER**

☎ +1 617 526 6000