

News from our Compensation & Benefits Group

Finally... Final 409A Regulations

On April 10, 2007, the Department of Treasury and the IRS issued final regulations under Code Section 409A.¹ As discussed in our prior Cooley Alerts,² Section 409A covers a wide range of nonqualified deferred compensation plans and arrangements (including stock option grants and separation arrangements) and imposes a number of strict requirements on such plans and arrangements for participants to avoid premature taxation, an additional 20% federal income tax, and interest on underpayments of tax.

Impact of Section 409A on nonqualified deferred compensation

Potential Scope. The final regulations provide that a “deferral of compensation” will exist if an employee has a “legally binding right” during one taxable year to compensation that is or may be payable to (or on behalf of) the employee in a later taxable year. This broad definition of deferred compensation would apply not only to traditional salary and bonus deferral plans, but also to stock options and other equity compensation awards, such as stock appreciation rights (SARs), restricted stock units (RSUs) and phantom units.

However, Section 409A does not apply to qualified employer plans (such as 401(k) plans), vacation leave, sick leave, compensatory time, disability pay and death benefit plans. Also excluded are rights to benefits that are excludable from income, certain foreign qualified plans, COBRA

reimbursements, D&O liability coverage (or other amounts paid to indemnify a service provider) and reimbursements for reasonable outplacement and moving expenses.

Immediate taxation and penalties. If a nonqualified deferred compensation plan or arrangement fails to comply with any of the new requirements, then (i) all compensation deferred under the plan or arrangement for an affected participant that is not subject to a substantial risk of forfeiture will become includible in the participant’s gross income for the taxable year in which the failure occurs, (ii) interest at the underpayment rate plus 1% will be imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture, and (iii) the amount required to be included in income would be subject to an additional 20% federal income tax penalty (plus an additional 20% state income tax for service providers who are subject to tax in California).

Transition rules. The final regulations are effective on January 1, 2008, but may be relied on before that date.

Stock options and stock appreciation rights (collectively “stock rights”)—in general

A stock right with respect to “service recipient stock” will not be considered “nonqualified deferred compensation” (and thus will not be subject to the Section 409A) if the stock right (i) is granted with an exercise

KEY ATTORNEY CONTACTS

Mark Bradford.....	650/843-5158 mbradford@cooley.com
Thea Chester.....	415/693-2139 tchester@cooley.com
Wendy Davis.....	650/843-5157 wdavis@cooley.com
Soo Kim.....	212/479-6760 skim@cooley.com
Michelle Lara.....	858/550-6011 mlara@cooley.com
Dan Meehan.....	720/566-4061 dmeehan@cooley.com
Buff Miller.....	650/843-5351 bmiller@cooley.com
Amy Muecke.....	858/550-6058 amuecke@cooley.com
Tom Reicher.....	415/693-2381 treicher@cooley.com
Paul Ritter.....	212/479-6198 pritter@cooley.com
Lisette Sell.....	415/693-2007 lsell@cooley.com
David Walsh.....	703/456-8021 dwalsh@cooley.com
Thomas Welk.....	858/550-6016 twelk@cooley.com

This information is a general description of the law; it is not intended to provide specific legal advice nor is it intended to create an attorney-client relationship with Cooley Godward Kronish LLP. Before taking any action on this information you should seek professional counsel.

Copyright © 2007 Cooley Godward Kronish LLP, 3000 El Camino Real, Palo Alto, CA 94306. Permission is granted to make and redistribute, without charge, copies of this entire document provided that such copies are complete and unaltered and identify Cooley Godward Kronish LLP as the author. All other rights reserved.

price (or base price, in the case of a stock appreciation right) that is not less than the fair market value of the underlying stock on the grant date,³ (ii) does not include a deferral feature other than the right of the holder to exercise the stock right in the future, and (iii) is granted on “service recipient stock.”

If the employee has, at the time of exercise, the right to receive dividends that have accumulated since the date of grant of an option, that right will be treated as if the option were granted at a discount, subjecting it to Section 409A. If the right to dividends is not contingent on the exercising the option, however, then the option will not be treated as discounted.

Section 409A also does not apply to incentive stock options (ISOs) and purchase rights granted under employee stock purchase plans (ESPPs).⁴

Amendments to stock rights

In general. A modification of a stock right will result in the deemed grant of a new stock right for purposes of Section 409A, and if the exercise price of the of the deemed new stock right is less than the fair market value of the underlying stock on the date of modification, the new stock right will be subject to Section 409A. A modification is defined as any change in the terms of the stock right that may provide the holder with a direct or indirect reduction in the exercise price, thus clearly excluding accelerations of vesting.

Extensions. The final regulations provide that the post-termination exercise period of a stock right may be extended until the earlier of: (i) the end of its original maximum contractual term, or (ii) ten years from the date of grant. In addition, if the stock right is at-the-money or underwater (*i.e.*, has an exercise price equal to or greater than the fair market value of the underlying stock at the time of the extension), then the stock right may be extended without being subject to the above limitations. Finally, extensions

of stock rights before April 10, 2007 are disregarded.

Valuation of company stock (private company)

The proposed regulations (detailed in prior Cooley Alerts) contained valuation factors that may be used to value private company stock for purposes of grants of stock rights. The final regulations add arm’s-length sales to the list of permissible valuation factors.

The proposed regulations also provided three presumptively reasonable methods of valuing private company stock that can only be rebutted upon a showing by the IRS that either the valuation method, or its application, was grossly unreasonable: an independent appraisal, a non-lapse repurchase formula⁵ and an “illiquid start-up” valuation. The last method permits the company to rely on a valuation evidenced in a written report and conducted by a person the company reasonably believes is qualified to make such valuation determination based on the person’s significant knowledge, experience, education or training. The final regulations liberalize the use of this method in two ways:

- ▶ the method is now available to companies that do not reasonably anticipate a merger or other acquisition within 90 days or a public offering within 180 days following the valuation (as opposed to the 12-month periods provided for acquisitions and public offerings in the proposed regulations); and
- ▶ the person performing the valuation may be presumed qualified to do so if a reasonable person, upon being apprised of the significant knowledge, experience, education and training of the person performing the valuation, would reasonably rely on the advice of such person in deciding whether to accept an offer to purchase or sell the stock being valued. The final regulations also clarify that “significant experience” means 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 in which the company operates.

Valuation of company stock (public company)

The final regulations are generally consistent with the proposed regulations (detailed in prior Cooley Alerts) regarding the valuation of stock traded on an established securities market. The final regulations provide that the fair market value of the stock may be determined based on: (i) the last sale before or the first sale after the grant, (ii) the closing price on the trading day before or the trading day of the grant, (iii) the arithmetic mean of the high and low prices on the trading day before or the trading day of the grant, or (iv) any other reasonable method using actual transactions in such stock as reported by such market. In addition, the determination may also be determined using an average selling price during a specified period of up to 30 days, provided that, before the beginning of the specified period, there is an irrevocable commitment to grant the stock right with an exercise price set using that average selling price.

Service recipient stock

A stock right will only be exempt from Section 409A if it relates to “service recipient stock.” Under a clarification in the final regulations, service recipient stock may be any class of stock treated as common stock for purposes of Code Section 305 of the issuing corporation, provided that such stock is not entitled to preferential dividend rights (but it may be entitled to preferential rights on liquidation). Service recipient stock may also include stock of any organization in a chain of organizations, all of which have a controlling interest⁶ in another organization, beginning with the parent organization and ending with the employer organization

(but not a subsidiary or “brother-sister” corporation).

Separation pay plans

In General. Subject to important exceptions discussed below, Section 409A applies to separation pay plans if they otherwise provide for the “deferral of compensation.” A deferral of compensation would exist under a legally binding right to compensation that will not be paid under any circumstances unless the employee has had a separation from service, whether voluntary or involuntary, including payments in the form of reimbursements of expenses incurred and the provision of in-kind benefits. The importance of whether or not Section 409A applies to a separation pay plan is that deferred compensation paid to “specified employees” of public companies upon a separation from service (whether or not from a separation pay plan) must be delayed for six months. A “specified employee” includes an officer with compensation of more than \$140,000 (for most terminations occurring in 2007). The determination of specified employees is discussed in greater detail below.

Exceptions to Section 409A’s application to separation pay plans. There are the following two primary exceptions (which may be used together) to the application of Section 409A to separation pay plans:

1. Short-term deferral: Separation payments that are payable only upon an involuntary termination of the employee’s employment are treated as subject to a substantial risk of forfeiture. Accordingly, such payments may be excluded from the application of Section 409A under the short-term deferral exception if the payments are made within 2½ months following the end of the taxable year of the company or of the individual, whichever is later, in which the involuntary termination occurred. In addition, the final regulations make clear that amounts payable upon certain

“good reason” resignations (discussed below) will be treated as if payable upon an involuntary termination of the employee. In addition, if each payment in an installment stream is designated as a separate “payment”—as permitted by the final regulations—then any such payment in the installment stream that is paid within the short-term deferral period will not be subject to Section 409A, even if the remainder of the stream of installment payments extends beyond the short-term deferral period.

2. Double pay exception: To the extent that separation pay is triggered by an involuntary termination (or a voluntary termination pursuant to a “window program”) and paid no later than December 31 of the second calendar year following the calendar year in which the separation from service occurs, it will not constitute deferred compensation up to the following limit: two times the lesser of (i) the employee’s compensation or (ii) \$225,000 (for 2007). Because only amounts paid beyond the permitted time period or in excess of the specified dollar limit will constitute deferred compensation subject to Section 409A, the employer may pay amounts falling within the exception without the six-month delay applicable to “specified employees” of public companies.

A “window program” is a program established by the employer to provide separation pay, where the window is open for a limited period of time (no longer than 12 months) to employees who resign during that period. For example, a “window program” could offer a 12-month period beginning with a change in control during which the employee has a right to resign from employment for any reason (or for specified reasons) and receive separation pay.

Resignations for good reason. The final regulations provide that a voluntary resignation may be treated as an involuntary

separation from service if certain conditions are met (for example, a resignation for good reason). The final regulations provide that a good reason must be defined to require actions taken by the employer resulting in a material negative change to the service provider in the service relationship, such as the duties to be performed, the conditions under which duties are to be performed, or the compensation to be received for performing services.⁷ The final regulations also include a safe harbor definition of good reason.

Determination of specified employees

The final regulations permit an employer to use an alternative method of identifying employees to be treated as “specified employees,” those who will be subject to the six-month delay in payments by a public company due to a separation from service.

A plan may use an alternative method for determining which employees are to be treated as “specified employees” if the alternative method (i) is reasonably designed to include all specified employees, (ii) provides an objectively determinable standard with no direct or indirect election to any employee regarding the application of the rule, and (iii) results in either all service providers or no more than 200 service providers being included in the class as of any date.

However, the preamble to the final regulations states that “if the list fails to include *any* individual who is a specified employee and that individual has a right to a payment of deferred compensation upon a separation from service without the required six-month delay, then the *plan* providing such right to such individual will not be in compliance with Section 409A.”⁸

Tax gross-up payments

The right to a tax gross-up payment (for example, the company’s payment of the

“golden parachute” excise tax and related taxes on that payment) is treated as deferred compensation. However, the tax gross-up payment is deemed to satisfy the requirements of Section 409A if the arrangement that provides the payment requires that it be made by the end of the employee’s taxable year following the year in which the employee remits the related taxes.

Plan aggregation rule

The final regulations continue to treat similar plans as a single plan under the plan aggregation rule, but expand the number of categories in which plans will be aggregated. Under the final regulations, each plan that is one of the following plan types will be aggregated with other plans of the same type: (1) account balance plans that involve an elective deferral, (2) account balance plans that do not involve an elective deferral, (3) non-account balance plans, (4) separation pay arrangements, (5) reimbursements and other in-kind benefits, (6) split-dollar life insurance arrangements, (7) certain foreign arrangements, (8) stock rights that are not exempt from Section 409A, and (9) other arrangements not described in (1)–(8) above. The expansion of aggregation categories is important because the effects of non-compliance with Section 409A and other aspects of its rules are limited by category.

What you need to do now

While plans subject to Section 409A have been subject to operational compliance since January 1, 2005, all plans must come within documentary compliance by December 31, 2007. Accordingly, each employer needs to determine which plans and arrangements are subject to Section 409A, and review plans and arrangements for changes needed to avoid Section 409A or to comply with its requirements, including the following:

- ▶ Add payment conditions to non-elective plans

- ▶ Add payment and election conditions to elective plans
- ▶ Review valuation practices for employer stock subject to stock rights
- ▶ Review definitions of “Change in Control” and “Good Reason”
- ▶ Review employment agreements, severance plans and other arrangements that provide separation pay for compliance with the six-month delay requirement for specified employees or for possible exclusion from such requirement
- ▶ Re-think stock option extension practices.

If you have questions about this *Alert*, please contact one of the attorneys listed above. ■

Notes

¹ The final regulations may be found at: www.treasury.gov/press/releases/reports/td9321.pdf

² See www.cooley.com/news/alerts.aspx?practiceid=37398720

³ Consistent with the regulations applicable to statutory stock options, the final regulations provide that an option is deemed to be granted when the granting corporation completes the corporate action creating a legally binding right. The action creating a legally binding right is not considered complete until the date on which the maximum number of shares that may be purchased under the stock right and the minimum exercise price are fixed or determinable, and the class of underlying stock and the identity of the service provider are designated.

⁴ See, Reicher, Miller and Welk, 381-3rd T.M., *Statutory Stock Options* for a detailed discussion of incentive stock options and employee stock purchase plans.

⁵ Under the final regulations, this formula need not be the same formula used by the company for other purposes.

⁶ The final regulations reduced the controlling interest threshold from 80% to 50%, and retain a 20% rule if the facts and circumstances indicate a legitimate business purpose.

⁷ The final regulations also provide other factors that help determine whether a separation from service for good reason is the equivalent of an involuntary separation from service: (i) the extent to which the payments upon a separation from service for good reason are in the same amount and are to be made at the same time and in the same form as payments available upon an actual involuntary separation from service, (ii) whether the employee is required to give notice of the right to resign for good reason, and (iii) whether the employer has a reasonable opportunity to remedy the condition constituting good reason.

⁸ See Section VII. C. 4. b. of the preamble. Note, however, that the final regulations do not include similar language on this point.