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EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION

SECTION 409A'S IMPACT ON PRIVATE COMPANIES

Section 409A was added to the Internal Revenue Code in October 2004 to provide strict rules governing the deferral of nonqualified compensation. Although the primary motivation of Congress in enacting Section 409A was to curb perceived compensation-related abuses by highly paid executives of public companies (*e.g.*, Enron), Section 409A's scope is not limited to public companies or to highly paid executives. It applies to, and will have a significant impact on, private companies and their employees, directors, and consultants. Thus, the discussion below will be important to private companies and their owners, including private equity funds that hold controlling interests in a portfolio of private companies.

We expect Section 409A to have the most significant impact on private companies in the following areas:

- Stock options and other equity compensation.
- Bonus programs.
- Employment and severance contracts.

The biggest impact is likely to be on the manner in which a private company determines fair market value ("FMV") for purposes of stock option grants. Recent IRS guidance, in the form of Notice 2006-4 released on December 23, 2005, and proposed regulations issued on September 29, 2005, address this subject. As explained below, the IRS notice and proposed regulations likely will affect the FMV determination and, over time, may cause many private companies to reconsider the basic terms of options. Indeed, unless there are changes in the Section 409A rules, some private companies may begin to question whether stock options should retain their position as the dominant long-term compensation vehicle for the company.

SECTION 409A OVERVIEW

Section 409A operates in three steps. First, it identifies compensation it considers "nonqualified deferred

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compensation" subject to its rules. Second, in the case of such compensation, it prescribes detailed rules that must be followed regarding the timing of deferral elections and the distribution of deferred amounts. Third, in the event of noncompliance, it imposes the following adverse federal tax consequences (the "Section 409A Tax Penalties"): (1) an inclusion of compensation in income at an earlier time—generally upon vesting—than would have occurred pre-Section 409A, (2) an additional 20 percent tax on the amount included in income, and (3) an interest charge at the IRS's interest rate for underpayments, plus 1 percent.

To assess the potential impact of Section 409A, the two questions that a private company should ask are: (1) Is the compensation nonqualified deferred compensation subject to Section 409A, and (2) if it is, what rules regarding deferral elections and distribution events must be followed to avoid the adverse Section 409A Tax Penalties?

STOCK OPTIONS[1]

Discount Stock Options Are Subject to Section 409A. Notice 2006-4 and the proposed regulations confirm that stock options that have an exercise price equal to the FMV of the underlying stock on the date of grant are not considered "nonqualified deferred compensation" and therefore are not subject to Section 409A.[2] On this basis, such options generally may continue to be granted without consideration of Section 409A. On the other hand, stock options with an exercise price that is less than the FMV of the underlying stock on the date of grant ("discount stock options") are considered "nonqualified deferred compensation" for purposes of Section 409A. In that case, the options are subject to the Section 409A Tax Penalties unless the terms of the options are altered in the manner described below to meet the applicable requirements set forth in Section 409A.

In the case of discount stock options, the penalties for noncompliance with Section 409A are severe. At a minimum, the affected executive will be required to include in income the option compensation (measured as the spread between the exercise price under the option and the FMV of the stock) at the time of vesting, rather than having such inclusion occur at the time of exercise. The income also would be subject to the 20 percent additional tax and interest. Moreover, there is a risk that the executive would be subject to tax in every year between the year of vesting and the year of exercise on any increase in the spread. The 20 percent additional tax and interest also would apply.

VALUATION INPUT PROVIDED BY IRS GUIDANCE

Valuation obviously is critical in determining whether a discount option has been granted. Guidance issued shortly after Section 409A was enacted stated that valuation could be determined under "any reasonable valuation method." Notice 2006-4 similarly provides, with respect to stock options granted on or after January 1, 2005 and before the effective date of the final regulations (expected to be January 1, 2007), that valuation could be determined under "any reasonable valuation method."[3]

Notice 2006-4 suggests, however, that once Section 409A regulations become final, it will not be sufficient that any reasonable valuation method is applied. Instead, the valuation will need to be reasonable as determined under the valuation metrics set forth in the final regulations. The proposed regu-

1. Similar rules and considerations apply to the extent that a private company utilizes stock appreciation rights in addition to or in lieu of stock options.

2. The proposed regulations, however, limit the rule that FMV options are exempt from Section 409A to options to acquire common stock and then only the class of common stock that as of the date of grant has the highest aggregate value, or a class of common stock substantially similar to such class of common stock (ignoring differences in voting rights). Accordingly, under the proposed regulations, an option to acquire preferred stock is subject to Section 409A even if the option is granted at FMV.

3. In a welcome move, Notice 2006-4 adopts a less strict standard with respect to stock options granted prior to January 1, 2005. In the case of such stock options, the only requirement is that the taxpayer exercised a "good-faith" attempt to determine fair market value.

lations give us some insight on what those valuation metrics may turn out to be.

The proposed regulations contain a list of specific factors to be taken into account in determining whether a valuation is reasonable. These factors are:

- The value of the company's tangible and intangible assets.
- The present value of future cash flows.
- The market value of similar companies (as determined in publicly traded sales or arm's-length private transactions).
- Control premiums and/or discounts for lack of marketability.
- Whether the valuation method is used for other purposes that have a material effect on the service recipient, its shareholders, or its creditors.

The proposed regulations further provide that a valuation will not be reasonable if it is more than 12 months old or if it fails to take into account all material information.

In addition, in an effort to provide more certainty, the proposed regulations designate three valuation methods that will be presumed to be reasonable. If one of the three methods is consistently applied, the valuation will be presumed to be FMV, and such presumption may be rebutted by the IRS only by showing that the valuation is "grossly unreasonable." The three valuation methods are:

ESOP Appraisal. A valuation by an independent appraisal that meets the requirements for an employee stock ownership plan ("ESOP") that is conducted within the prior 12 months. (Because of the cost associated with such appraisal, we believe that many companies will find this alternative to be impractical.)

Formula Price. A valuation based on a formula, provided such formula is also used for all noncompensatory purposes requiring the valuation of stock, including regulatory filings, loan covenants, and sales to persons other than employees. (We believe the requirement that the formula price must be used for all noncompensatory purposes will make this alternative unattractive to most private companies.)

Valuation of a Start-Up Company. A valuation of the illiquid stock of a start-up company prepared by a person with significant knowledge and experience that is evidenced by a written report taking into account the relevant factors described above. For this purpose, "illiquid stock" of a start-up company means stock of a company that is in its first 10 years of the active conduct of trade or business and has no class of stock that is publicly traded. The proposed regulations further specify that this method is not available if the company reasonably contemplates a change in control or IPO within the next 12 months.

For private equity funds, the proposed regulations provide little specific comfort. In our experience, private equity funds frequently cause management options to be issued at or shortly after the closing of a new platform acquisition at a price equal to the "buy-in" price used by the fund sponsor. Although the proposed regulations do not specifically authorize this approach, we would assume that such approach is permissible, given that such options are clearly issued at FMV. For options issued subsequent to a new platform acquisition (*e.g.*, to employees hired later), the proposed regulations are equally unhelpful, since all of the "safe harbors" are problematic in most circumstances.

POSSIBLE RESPONSES TO PROPOSED REGULATIONS

In light of the proposed regulations, we believe there are four alternatives for a private company to consider.

Do Nothing Different. Since the regulations have been issued in "proposed" form, they are not currently binding. Before the regulations are finalized and become effective (currently scheduled to be January 1, 2007), the guidance on valuation and Section 409A's application to discount stock options may change.

Although a private company may be tempted to "do nothing" in light of the above, we do not recommend this approach. While the regulations are not currently binding, Section 409A generally became effective January 1, 2005, and according to the IRS, it applies to any discount stock option that is granted or that becomes vested after January 1, 2005. Notice 2006-4 confirms this point. As noted above, the penalties for noncompliance in the case of a discount stock option are severe. Therefore, unless a private company has a solid basis

for otherwise believing its options are granted at FMV (*e.g.*, contemporaneous sales to third-party investors), reliance on the proposed regulations or some other reasonable valuation method should be considered.

Apply Proposed Regulations. Application of the valuation guidance set forth in the proposed regulations can come in two forms. At one extreme, a private company may decide to adopt one of the three prescribed valuation methods. We recognize in many cases that adoption of one of the three methods may not be practical either, because of the requirements to qualify or the associated cost. In such cases, the private company should, at a minimum, consider preparing an internal appraisal or report that takes into account each of the valuation factors set forth in the proposed regulations, as well as any other relevant factors. In the case of grants made prior to the finalization of the regulations, such an internal valuation may be sufficient to meet the standard of any reasonable valuation method. For private equity funds, such a requirement would not presumably be too burdensome, given the expertise of such funds in business valuations.

Another way to comply with the proposed regulations is to grant options that qualify as "incentive stock options" under Section 422. The proposed regulations, as well as earlier guidance from the IRS, exempt incentive stock options from coverage under Section 409A. While it is true that an option must be priced at FMV to qualify as an incentive stock option, the standards for establishing FMV under the incentive stock option rules may be more liberal than the standards under Section 409A. Companies considering incentive stock options need to take into account the different tax treatment applied to the company and to the optionee resulting from incentive stock options, as compared to nonqualified stock options.

Comply with Section 409A Rules for Discount Stock Options. A third alternative would be to accept the conclusion that the option is subject to Section 409A but to recognize that the adverse Section 409A Tax Penalties are imposed only if such option does not comply with the Section 409A rules for deferral elections and the timing of distributions. In general, a discount option that is exercisable at any time after vesting will not comply with the Section 409A rules. For compliance with Section 409A, the date or event requiring exercisability generally must be established within 30 days of grant (assuming a minimum 13-month vesting period), and such date or event must be one of the permissible events enumerated in the statute (*i.e.*, separation from service, disability, a specified time or pursuant to a fixed schedule specified under the plan at the date of grant, death, a change in ownership or control of the corporation, or the occurrence of an unforeseeable emergency).

If a private company encounters a situation where there is a significant risk that the option may be granted at discount (or where the company believes that it is desirable to grant a discount option for business reasons), the company may want to consider this alternative. One approach would be to provide that the discount option must be exercised upon vesting (or no later than March 15 of the year following the year of vesting) or in a particular year following vesting. Under this approach, the optionee would still be required to recognize income on exercise, but he or she would not be subject to the additional tax and interest imposed by Section 409A. Alternatively, a discount option may be subject to a vesting schedule but be exercisable only upon a change in control of the corporation (also a permissible event under the new rules). While these two approaches offer the optionee less flexibility and control over the exercise of the option, they would permit discount stock options to be utilized as a compensation mechanism in the world of Section 409A.

Consider Alternative Compensation Forms. Finally, a private company in certain circumstances may want to consider alternative forms of long-term compensation that are not subject to Section 409A. Two such forms are restricted stock and certain bonus arrangements. In the case where FMV is low, restricted stock (coupled with a Section 83(b) election to be immediately taxed on the FMV of the stock) may be particularly attractive. Indeed, the cash outlay associated with Section 83(b) elections may be less than the appraisal fees if the company attempted to value the stock reasonably in order to grant an option. Alternatively, in the case where the business arrangement is that the executive is entitled to share in appreciation in the company's shares only if the executive remains employed until the date of a change in control or IPO, a contract providing for a cash bonus in such event may be a better choice.

OTHER THOUGHTS ON STOCK OPTIONS

Two additional considerations may be taken into account with respect to stock options. First, the proposed regulations confirm that certain modifications of the terms of an outstanding "in the money" stock option (including options granted or vested prior to December 31, 2004) will be treated as a grant of a new stock option subject to Section 409A. The proposed regulations provide examples of certain changes that will and will not result in a deemed grant of a new option subject to Section 409A. For example, the proposed regulations provide that the acceleration of a right to exercise will not result in a new grant. On the other hand, the extension of the time in which to exercise will cause the option to be subject to Section 409A from the date of original grant (whether or not the option is "in the money" at the time of extension).[4] The bottom line is that a private company considering a change in the terms of outstanding options should consult its tax advisor to consider the possible application of Section 409A.

Finally, the proposed regulations address corrective action in the case of outstanding discount options subject to Section 409A. The proposed regulations extend the period to fix such option until December 31, 2006. Companies with outstanding discount options subject to Section 409A should consult with their tax advisors to explore potential fixes.

ANNUAL BONUS COMPENSATION

Section 409A also may affect a private company's policy of paying an annual bonus. Under the proposed regulations, a Section 409A deferral of compensation generally does not occur, and consequently compensation would not be subject to the requirements of Section 409A if such compensation is paid within 2½ months of the end of the calendar year in which the compensation becomes vested (or, if later, within 2½ months of the end of the company's tax year in which the compensation becomes vested). This rule is commonly referred to as "the short-term deferral" exception. Thus, with respect to an annual bonus program of a calendar-year company where the employee becomes vested in his right to the bonus on December 31, a bonus based on 2006 performance would not be subject to Section 409A if the bonus is paid by March 15, 2007.

One issue addressed by the proposed regulations is whether, in order to qualify for the short-term deferral exception, a plan or agreement needs to specify in writing that payment is required within the 2½-month period. The proposed regulations do not require a written provision. However, they do include several benefits for plans and agreements that include a written requirement. We therefore recommend that annual bonus plans include such a provision. In some cases, this may require private companies to document their annual bonus plans in writing. Companies have until December 31, 2006, to meet Section 409A's documentary requirements.

One planning opportunity for calendar-year companies that expect difficulties in meeting the March 15 deadline is to extend the date on which employees become vested in their bonuses. If the individual must remain employed through March 1, 2007, to become entitled to the 2006 bonus, it should be the case that the amount remains subject to a substantial risk of forfeiture until such date. If this is correct, the bonus would not need to be paid until March 15, 2008, to qualify for the short-term deferral exception. The IRS may challenge this planning opportunity when the additional time period is not significant or where the company does not consistently require forfeiture when an employee terminates before the extended date.

SEVERANCE PAYMENTS

A final area that merits some comment involves severance payments. Prior to the issuance of the proposed regulations, there was a concern that such payments could be subject to Section 409A. While the proposed regulations do not include a blanket exclusion for severance payments, the regulations do include two provisions that will result in the exclusion of certain severance payments from consideration under

4. Under the proposed regulations, however, an extension will not cause a Section 409A problem if the exercise period is not extended beyond December 31 of the year in which the right otherwise would have expired (or, if later, the 15th day of the third month following the date on which the right otherwise would have expired).

Section 409A. In many cases, private companies will benefit from these provisions.

First, the proposed regulations confirm that the short-term deferral exception described above applies to severance payments made on account of an involuntary termination of employment, provided the payments are made within 2½ months of the end of the year in which the involuntary termination occurs. The second provision excludes severance payments made over time, provided (1) the aggregate payments do not exceed the lesser of two times the executive's annual compensation or $420,000 (indexed) and (2) all payouts are made no later than December 31 of the second calendar year following the year of termination.[5] To the extent that either of these limits is exceeded or if the payments are made on account of termination for good reason rather than on account of an involuntary termination, Section 409A may apply, and a tax advisor should be consulted.

LAWYER CONTACTS

For further information, please contact your principal Firm representative, any member of the Firm's Employee Benefits & Executive Compensation Practice, or one of the lawyers listed below. General e-mail messages may be sent using our "Contact Us" form, which may be found at www.jonesday.com.

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5. The proposed regulations also provide for an exclusion for certain reimbursement arrangements but again limit the exclusions to expenses incurred and reimbursed before December 31 of the second calendar year following the year of termination.

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