

Alert

May 2005

Section 409A Creates Tax Consequences for Stock Options

“...the immediate valuation issue is the determination of fair market value of the stock granted pursuant to a stock-based compensation plan.”

VRC NEWS

VRC will be presenting a webcast, **"Fairness Opinion Valuation Methods"** on June 28 at 1:00 central time. Register at www.valuationresearch.com/registration.htm.

Section 409A, a provision of the American Jobs Creation Act of 2004, provides for the onerous taxation of compensation payable under non-qualified deferred compensation plans unless the compensation meets stringent new requirements, including that the compensation not be paid until specified dates and that the recipient have only limited rights to elect to change the timing of the payments. The intent of Section 409A is strict enforcement of the constructive receipt rules applicable under such plans. Section 409A's application is broad in two significant respects. First, it applies to essentially all stock-based, nonqualified deferred compensation plans. Second, it extends to Section 83 property-for-services transactions.

The provisions of Section 409A regarding the mechanics of elections to deferred compensation and acceleration events are beyond the scope of this *Alert*. Rather, the immediate valuation issue is the determination of fair market value of the stock granted pursuant to a stock-based deferred compensation plan. The IRS has issued Notice 2005-1 in an effort to provide guidance on the scope and application of Section 409A. Notice 2005-1 details the transition rules for Section 409A, which is generally effective for amounts deferred on or after January 1, 2005. Notice 2005-1 confirms Section 409A's application to nonstatutory stock options, stock appreciation rights and other equity-based compensation.

Nonstatutory stock option grants will be subject to deferred compensation taxation unless the grant provides that 1) the exercise price may never be less than the fair market value of the stock on the date of the grant, 2) receipt, transfer or exercise of the option is subject to the Section 83 property-for-services constructive receipt provisions, and 3) there is no feature for the deferral of income other than that provided in Treasury Regulation 1.83-7. Section 83 provides for taxation of a stock option based on its fair market value at date of grant determined by reference to public trading of the stock or other allowable valuation method. Taxation is avoided only if the individual's right to the underlying stock is subject to substantial risk of forfeiture within the meaning of Section 83.

Stock appreciation rights (SARs) are subject to deferred compensation taxation under Section 409A unless the grant provides that 1) the value of the stock the excess over which the right provides for payment upon exercise (SAR exercise price) may never be less than the fair market value of the underlying stock on the date the right is granted, 2) the stock of the service recipient (generally the company itself) is traded on established securities markets, 3) only such stock of the recipient can be received in settlement of the stock appreciation right upon its exercise, and 4) the stock appreciation right does not include any feature for deferral other than the deferral of recognition of income until the exercise of the stock appreciation right.

The key valuation issue in the Sec. 409A application to nonstatutory stock option grants and stock appreciation rights is fair market value determination of the underlying stock in relation

continued on back...

Section 409A Creates Tax Consequences for Stock Options

...continued from front

"...In view of the stakes and the absence of any clear guidance from the IRS as to what constitutes a 'reasonable valuation method,' employers should seriously consider consulting with valuation professionals on these issues."

to the exercise price. Any difference or discount, where the fair market value is greater than the exercise price at the date of grant, will cause the nonqualified stock option or stock appreciation right to constitute deferred compensation that is subject to Sec. 409A. Most importantly, conventionally designed options and SARs would violate Sec. 409A because the holders have the discretion to elect when to exercise the right and to be paid the inherent compensation. The consequence of a violation of Sec. 409A is that the holder would be taxable on the value of the option or SAR at the time of vesting (without regard to when the right is exercised), at ordinary income tax rates, plus an additional 20% penalty tax rate. Furthermore, the Sec. 409A taxation is not limited to the discount between the exercise price and the fair market value of the option on the date of grant but rather on the date of vesting of each installment, as it vests.

Notice 2005-1 states that fair market value can be determined based on trading prices for publicly traded companies. In situations where market prices are unavailable, Notice 2005-1 indicates that any reasonable valuation method may be used, including the valuation method described in Section 20.2031-2 of the Estate Tax Regulations. In addition, a valuation analysis of a nonqualified stock option plan may be necessary to address the provision of Notice 2005-1 which provides that if, under the terms of the option, the amount required to purchase the stock is or could become less than the fair market value of the stock at the date of the grant, the grant of the option may provide for deferred compensation within the meaning of Sec. 409A.

According to Jim Barrall, a tax and executive compensation expert who chairs the Benefits and Compensation Group of Latham & Watkins LLP, "The tax consequences to employees and other service providers of having stock options or SARs taxable under IRC Sec. 409A are potentially disastrous. As a result of Sec. 409A, employers have a burden to do their best not to grant options or SARs with a discounted exercise price and, therefore, to use a "reasonable valuation method" to determine the fair market value of the stock underlying the options or SARs. In view of the stakes and the absence of any clear guidance from the IRS as to what constitutes a "reasonable valuation method," employers should seriously consider consulting with valuation professionals on these issues."

Notice 2005-1 is the first in a series of documents the IRS plans to issue to provide guidance regarding the application of Sec. 409A. The IRS and the Treasury Department plan to incorporate the guidance from Notice 2005-1 into a more comprehensive doctrine in 2005. For questions concerning Sec. 409A, contact your Valuation Research representative or Justin Johnson at (415) 277-1803. **VR**

Editor: Theresa Miller

© Valuation Research Corporation. All rights reserved.

**Valuation
Research**[®]
Corporation

Valuation Research Corporation
Corporate Office:
330 East Kilbourn Avenue
Milwaukee, WI 53202
414.271.8662

www.valuationresearch.com

Austin	512.238.1925
Boston	617.342.7366
Chicago	630.990.2626
Cincinnati	513.579.9100
Milwaukee	414.271.8662
New York	212.983.3370
Princeton	609.452.0900
San Francisco	415.277.1800

International Affiliates:

Argentina
Australia
Brazil
Chile
Mexico
Spain
United Kingdom
Venezuela