The Brave New World of Equity-Based Compensation Post-409A

Employers must move quickly to review all equity-based compensation arrangements and determine if they are covered by the new rules and can be grandfathered.

Equity-based compensation arrangements are a popular and important part of many employers' compensation strategies. New Section 409A of the Internal Revenue Code, enacted October 3, 2004, as part of the American Jobs Creation Act of 2004, effective on January 1, 2005, adds several rules for equity-based compensation arrangements that are considered nonqualified deferred compensation plans. Because the Act broadly defines a nonqualified deferred compensation plan as "any plan that provides for the deferral of compensation," it is not readily apparent to what particular types of equity-based compensation arrangements Section 409A might apply.

Recent Treasury Department guidance, Internal Revenue Service (IRS) Notice 2005-1, provides helpful assistance in determining what types of equity-based compensation arrangements are and are not covered by Section 409A's nonqualified deferred compensation plan rules and how to apply those rules.

If an arrangement is covered but does not comply with Section 409A's rules, amounts deferred become immediately taxable and subject to a 20% tax penalty. Worse, Section 409A's rules aggregate all equity-based arrangements together. If two aggregated plans are covered by the rules and only one fails to meet the rules, the immediate taxation and 20% penalty apply to both arrangements.

Because high-profile corporate abuses involving these types of arrangements put them high on the list of topics examined by the IRS, determining whether an equity-based compensation

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arrangement is covered by Section 409A, and if covered, making sure it complies with the new rules, are critical. The reminder of 2005 is the time to act because the guidance provides broad transition relief this year and allows almost any shortcoming to be fixed. This article explores when the new rules apply or do not apply to common equity-based compensation arrangements, as well as the key steps to take during 2005 to protect such arrangements, and those who participate in them, from Section 409A’s bite.

Nonqualified Plans and Equity-Based Compensation

All arrangements under which a person performs services in one year that are at least in part paid for in a later year are fair game and may be considered a “deferred compensation plan” within the broad scope of Section 409A’s rules. The service provider need not be an employee: Arrangements with independent contractors, outside directors, and partners are included, although for purposes of simplicity this article primarily will refer to “employees.”

The term “plan” is also somewhat misleading. Any arrangement providing these types of benefits is potentially subject to the new law, even if it is a single agreement that applies to only one individual.

Examples of equity-based compensation arrangements that may be considered deferred compensation plans include:

- Stock options—the employer grants an employee the right to purchase a specified number of shares of company stock at a fixed price at a future date or dates, regardless of the fair market value price of the stock on that future date.
- Stock appreciation rights—the employer grants an employee the right to a payment in cash or shares equal to any increase in the value of company stock as measured from the grant date to the grant's expiration date.
- Restricted stock units—the employer agrees to pay an employee a fixed number of shares of company stock at a future date or dates.
- Restricted stock—the employer grants stock to an employee subject to restrictions on its transfer, usually completion of a vesting period.
- Employee stock purchase plans—the employer allows employees to purchase company stock at a fixed discount.
- Phantom stock—the employer agrees to pay an employee cash at a future date or dates based on a number of shares of company stock stated on the date of grant and the value of those shares at the time of payment.

Arrangements Automatically Exempt

Large swaths of equity-based compensation arrangements are automatically exempt from Section 409A's rules. If an arrangement meets one of the exceptions, no further analysis need be done.

- Tax-qualified retirement plans. Tax-qualified retirement plans are not nonqualified deferred compensation plans under Section 409A, even if they provide for equity-based deferred compensation. For example, employee stock ownership plans (ESOPs), 401(k) plans that provide for matching contributions in company stock or participant-directed account plans that offer a company stock investment option all fall outside the Section 409A basket.

- Arrangements with no or only short-term deferrals. An arrangement that permits no, or only a short-term, deferral of payment following the date a substantial risk of forfeiture expires is not subject to Section 409A's rules. A deferral is “short-term” only if “at all times” the arrangement requires payment no later than two and a half months following the end of the tax year of vesting. The tax year for this purpose can be either the employee’s or the employer’s tax year, whichever ends later. Many restricted stock unit, restricted stock and phantom stock plans and other equity-based bonus plans will fall within this exception.

It is not clear if the “at all times” requirement means that the underlying plan, as well as the grant, must require payment by the deadline. The
IRS informally has indicated that the deadline can be in the grant only, as long as the underlying plan would not permit the grant's provisions to be overridden. For example, if a restricted stock unit grant requires payment to the employee by the March 15 following the calendar year of vesting, the requirements generally will be met, but not if the underlying plan allows employees to defer that payment to a later year by notifying the employer in advance. Any possibility of deferral beyond the short-term deferral period, whether by action of the employer or the employee, will subject the arrangement to Section 409A's rules.

The key to the short-term deferral exception is the meaning of "substantial risk of forfeiture." A substantial risk of forfeiture for 409A purposes exists only if the employee will lose his or her rights to any benefit if (a) he or she fails to continue to work for the employer until the specified time or (b) he or she or the company fails to meet by the specified time a condition specifically related to a purpose of the compensation (such as the attainment of a prescribed equity value). The possibility of this risk of loss must be substantial. Forfeitures for violating noncompete agreements or on account of "for cause" terminations will not be considered substantial risks of forfeiture. In general, the IRS is concerned about potential abuses in this area and will interpret substantial risk of forfeiture narrowly.

An ISO plan is easy to spot. Generally, it must be approved by the employer's shareholders, be broad-based as to eligibility, specify the total number of shares subject to the options, grant options and require their exercise within a 10-year period (measured from various dates), impose a $100,000 per year per employee stock value limit on the options granted and exclude employees who own more than 10% of the employer's stock, unless a 110% of fair market value option price and five-year exercise waiting period are used for them. An ISO plan will probably be labeled as such, either in its title or prominently within its text.

An ESPP is similarly easy to identify. It must, in part, be approved by the employer's shareholders, generally apply to all of the employer's employees, exclude employees who own more than 5% of the company's stock and impose a $25,000 per year per employee stock value limit on the options granted. As with an ISO plan, an ESPP is also likely to be labeled as such in its documentation.

Other Significant Exclusions
Determining whether Section 409A rules apply to any other equity-based compensation arrangement is not so straightforward. The IRS has, however, provided some helpful exceptions. These exceptions will apply even if the stock in question is the stock of a parent or other related company, as long as the company is connected to the employer at an 80% ownership level.

> **Nonstatutory stock options.** If the arrangement is a stock option plan other than an ISO plan, for example, a nonstatutory stock option (NSO) plan, it may still escape Section 409A's rules, but only if it meets the following requirements:

1. The option's exercise price may never be less than the fair market value of the underlying stock on the date the option is granted.

2. The receipt, transfer or exercise of the option is subject to taxation under Section 83 of the Internal Revenue Code as a transfer of property.

3. The option does not include any feature that permits the deferral of compensation other than the deferral of the recognition of income until the exercise or disposition of the option.

The fair market value of the stock may be determined using any reasonable method. That is an easy task if the employer's stock is publicly traded. It is not so easy if the employer is privately held, especially if an individual or a small group of individuals own a controlling interest in the employer. Alternative measures, such as using a book value measure, will not suffice.

Both the option grant and the underlying plan should be reviewed for the fair market value requirement. Even when the option grant sets the exercise price at the fair market value of the stock...
on the date the option is granted, if the underly-
ing NSO plan document permits an option's exer-
cise price to be changed to any amount less than
that value, for example, in the event the options
are underwater, the arrangement likely will not
meet the fair market value requirement. Section
409A's rules will then apply.

➤ **Stock appreciation rights.** The exception for
stock appreciation rights (SARs) is even narrower.
An SAR arrangement will escape Section 409A's
rules only if it meets the following requirements:

1. The employer's stock is traded on an estab-
lished securities market (i.e., it is publicly traded).

2. The increase in value must be measured
from an amount that is not less than the fair mar-
ket value of the underlying stock on the date the
appreciation right is granted.

3. Only the employer's publicly traded stock
may be delivered to the employee in settlemen-
t of the SAR when exercised by the employee. If the
employer has agreed to purchase the stock deliv-
ered in settlement of the SAR, this requiremen-
t will not be met, even though the payment is orig-
inally made in stock.

4. The SAR arrangement does not include any
feature for the deferral of compensation other
than the deferral of recognition of income until
the exercise of the right.

Because SARs are often used by privately held
companies, this requirement alone knocks out
many of these arrangements from the exception
and subjects them to Section 409A’s rules, unless
they meet the limited exception below.

➤ **Existing SAR arrangements.** Even if an em-
ployer's stock is not publicly traded, or the SAR
arrangement permits payment in cash when the
SAR is exercised, the SAR arrangement has an-
other shot at avoiding Section 409A’s rules. The SAR
arrangement will escape Section 409A’s rules if it
was in place on or before October 3, 2004, and
contains these provision

1. The SAR exercise price may never be less
than the fair market value of the underlying stock
on the date the appreciation right is granted.

2. The SAR arrangement does not include any
feature for the deferral of compensation other
than the deferral of recognition of income until
the exercise of the right.

Under this limited exception, the fair market
value of the stock will be determined in the same
manner as used for NSOs (i.e., by using any rea-
sonable method), and the same closely held busi-
ness valuation problems will exist. This exception
may be short-lived or narrowed. The Treasury De-
partment has explicitly indicated that it is fair
game for future guidance and the exception may
be changed or eliminated.

**Grandfathering**

If an employer's equity-based compensation
arrangement was in place on or before October 3,
2004, amounts deferred prior to 2005 can be
grandfathered and avoid compliance with Sec-
tion 409A’s rules. For purposes of the grandfa-
thering rule, the “amount deferred” is the amount
earned and vested that is available to the employ-
ee on December 31, 2004, or that would be avail-
able if the right were immediately exercisable, ex-
cluding any exercise price that must be paid by
the employee. Earnings on these amounts—for
example, earnings attributable to stock apprecia-
tion—are also grandfathered. Amounts deferred
after 2004 are subject to Section 409A’s rules, if
they do not fall into any of the other exceptions.

An important string is attached to this grand-
father relief: no “material modifications” to the
grandfathered benefit can be made after October
3, 2004. Generally, any addition or enhancement
of a benefit or right under the arrangement,
whether by amendment or the employer's exer-
cise of any discretion (such as to accelerat
vesting to a date before 2005), will constitute a
material modification. Even an addition or en-
hancement of a benefit or right that otherwise
meets Section 409A’s rules will be a material modi-
fication. For example, if an existing restricted
stock unit plan is amended after October 3, 2004,
to add a provision to make distributions of grand-
fathered benefits on a “change in control,” the
amounts deferred and vested before 2005 will
lose their grandfather protection even if “change
in control” is defined as required under Section
409A’s rules.

The reduction or elimination of an existing
benefit is not considered a material modification.
Furthermore, the exercise of discretion an em-
ployer has under the existing arrangement as to
the time or manner of payment is not a material
modification.
What to Do During 2005
If an equity-based compensation arrangement does not satisfy the stated requirements for express exemption from Section 409A's rules, a transition period running through December 31, 2005, offers the employer an opportunity to decide what to do: grandfather, terminate, amend to comply with the exemption requirements, or amend to comply with Section 409A's requirements.

➢ Decide whether to grandfather pre-2005 deferred amounts. For each equity-based compensation arrangement that was in place before October 3, 2004, the employer should determine what, if any, pre-2005 deferred amounts have grandfathered protection available and whether that protection should be retained. The employer may choose not to retain grandfathered protection depending on (a) how difficult it is to track the grandfathered amounts separately from new grants, (b) how close the existing provisions are to the new law's requirements and how important those provisions are to the arrangement, (c) whether substantive changes to the arrangement at some point are expected in any event that could amount to substantial modifications and (d) the ability of the organization to ensure that no substantial modifications are made to the protected amounts through the remainder of the life spans of the potentially grandfathered amounts.

➢ Terminate the arrangement. During 2005, a one-time opportunity is offered to terminate existing arrangements. The employer should determine whether the current arrangement is meeting the company's goals for the grandfathered amounts and whether the new Section 409A rules will hinder the arrangement's effectiveness on a go-forward basis. If not, 2005 is the last opportunity to terminate the arrangement and distribute all outstanding amounts. All or any portion of the plan can be terminated. After 2005, distributions cannot be made merely because a plan terminates; although employees could be stopped from earning any additional benefits following a freeze date, after 2005 distributions of already earned benefits would have to be deferred until a distribution event under the plan occurs, such as termination of employment.

The employer may also permit employees participating in the arrangement to individually terminate their participation during 2005. This may be an attractive option to employees where, for example, the arrangement has historically permitted employees to defer the payment of their grant and this will no longer be allowed, or where an option with a multiyear exercise period is converted under the new rules to one with a fixed payment date.

The reduction or elimination of an existing benefit is not considered a material modification.

➢ Amend the arrangement out of section 409A's coverage. Depending on the employer's equity-based compensation goals, it may be relatively easy to amend an arrangement before 2006 so that it is no longer subject to Section 409A's rules. For example, if an NSO plan permits a discounted exercise price, the employer can amend the plan and/or grants, as necessary, to permit only an exercise price pegged at the fair market value of the company's stock on the option's grant date. As long as the plan's provisions do not permit an override of a stated exercise price in an option grant, amendment of just the individual option grants, without amendment of the plan, should suffice to remove the options from Section 409A's rules. Many arrangements can be amended out of Section 409A's coverage merely by requiring payment during the two and a half-month short-term deferral window following the end of the tax year in which vesting occurs.

➢ Amend the arrangement to comply with section 409A's rules. If it is not practical or desirable to amend an arrangement out of Section 409A's coverage, or to terminate the arrangement, it must be amended before 2006 to comply with Section 409A’s rules, unless, by happy coincidence, it already meets those requirements. An arrangement must also be operated in good faith compliance with the new rules during the entirety of 2005, even though the amendment is delayed until later in the year. This means that the employer must decide how to comply with the new law before any payments are made pursuant to the arrangement. For each arrangement, the
key items to check and, if necessary, amend are these:

- **Initial deferral elections and distribution events.** The arrangement must require that an "initial election" specify when the amount will be paid. An up-front, specified schedule will meet this requirement, but an open-ended time period during which an employee can exercise an option (or other right) does not meet the requirement. The arrangement may provide for payments only on fixed dates or on account of an employee's death, separation from service or becoming disabled (as specifically defined in Section 409A); on occurrence of an unforeseeable emergency; or on a change in the ownership or control of the employer (as specifically defined under Section 409A). It appears that the IRS will allow an arrangement to include provisions requiring payment on the earliest of all or any of these events but not the latest of these events or at the employer's discretion. All but the first of these events are freighted with additional dos and don'ts, and making sure an arrangement states them correctly is a critical detail.

The limits on the times that payment can be made virtually destroy any option plan that does not meet one of the stated exceptions from 409A coverage, because the timing of the exercise of the option must be set in advance and cannot be exercised at a time of the employee's choosing. Restricted stock, phantom stock, and certain SARs, however, will probably be easier to tie to specific distribution dates.

- **Subsequent deferral elections.** Arrangements that permit subsequent deferral elections, that is, an ability to push back the payment date, may need to be amended to meet Section 409A's restrictions as to the date by which such elections must be made and the date on which they may take effect. Any payment to be made initially at a specified time or under a fixed schedule can be deferred to a subsequent date only if the election is made at least 12 months before the date of the first scheduled payment and the new payment date is at least five years after the original payment date.

- **Acceleration of payment.** If the arrangement permits the acceleration of a payment, or a schedule of payments, it must be amended to meet Section 409A's acceleration of payment rules. Those rules generally prohibit any acceleration of payment except under special circumstances: to comply with a domestic relations order, to pay employment taxes or to comply with federal divestiture requirements. A plan can also provide for cash-outs of certain defined de minimis amounts or of small plan-specified amounts.

Acceleration of vesting, as opposed to distribution, is still permitted, even if the acceleration of the vesting accelerates the payment. For example, if a phantom stock benefit is vested in three years but paid at termination of employment, under 409A the plan can allow the employer to accelerate the vesting, and make the distribution, for employees subject to a reduction in force before the three-year period is completed. The distribution itself, though, must still meet the distribution timing requirements—for example, at termination of employment.

**Conclusion**

Section 409A's rules are broad—they apply to many, but not all, equity-based compensation arrangements. SAR arrangements for privately held companies will not pass muster under the new rules unless they were in place on October 3, 2004, and meet the limited exception discussed above—that is, they meet specific fair market value and no deferral of compensation requirements. That limited exception may be narrowed or eliminated in future Treasury Department guidance. Both SAR and NSO plans with difficult-to-value stock and open-ended option exercise periods will also flounder under the new rules. For these arrangements, an exercise date must be set in each grant to meet the rules' fixed payment date requirement, which will likely vitiate their advantages entirely.

Now is the time to carefully review equity-based compensation arrangements and determine if those arrangements are or are not covered by Section 409A's rules. If any arrangement is covered by the rules, there is a good chance that the grants made and vested (the "amounts deferred") before 2005 will be grandfathered. Any non-grandfathered grants and the underlying arrangement can be amended during the 2005 transition period to either avoid the rules entirely or to comply. Failure to act risks serious consequences to any noncompliant arrangement: immediate taxation to affected employees and a 20% penalty.
# EXHIBIT 1

## Equity-Based Compensation Arrangements

<table>
<thead>
<tr>
<th>Arrangement Type</th>
<th>Key Features</th>
<th>Not Subject to Section 409A Rules</th>
<th>Subject to Section 409A Rules&lt;sup&gt;a&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax-qualified plans</td>
<td>Complies with Internal Revenue Code Section 401(a).</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>ISO</td>
<td>Complies with Internal Revenue Code Section 422.</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>ESPP</td>
<td>Complies with Internal Revenue Code Section 423.</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>NSO</td>
<td>Not an ISO or ESPP; option to purchase shares of company stock at a fixed price or discount at a future date.</td>
<td>If option price is at least FMV at time of grant, taxed under Internal Revenue Code Section 83, and no deferral other than option exercise.</td>
<td>Otherwise, yes&lt;sup&gt;b&lt;/sup&gt;</td>
</tr>
<tr>
<td>SAR</td>
<td>Right to payment in cash or shares equal in value to any increase in value of company stock as measured from the date of grant.</td>
<td>If (a) company's stock is publicly traded, settlement may only be in company stock, no other deferral, and exercise price is never less than FMV at date of grant, or (b) arrangement was in effect on 10/3/04, exercise price never less than FMV at date of grant and no deferral of income beyond exercise.</td>
<td>Otherwise, yes&lt;sup&gt;b&lt;/sup&gt;</td>
</tr>
<tr>
<td>RSU</td>
<td>Right to payment of cash or company stock based on future value of that stock.</td>
<td>X&lt;sup&gt;c&lt;/sup&gt; (short-term deferral, though, often helpful here)</td>
<td></td>
</tr>
<tr>
<td>Restricted stock</td>
<td>Grant of stock to an employee subject to restrictions on transfer and subject to a substantial risk of forfeiture.</td>
<td>X&lt;sup&gt;d&lt;/sup&gt; (although under normal circumstances, short-term deferral rule will exempt these arrangements)</td>
<td></td>
</tr>
</tbody>
</table>

<sup>a</sup> That is, deferral of compensation.

<sup>b</sup> Subject to the short-term deferral rule for all arrangements, and the grandfather and transition rules for arrangements in existence on or before October 3, 2004.

Exhibit 1 summarizes the types of equity-based compensation arrangements and the features in each arrangement to check to determine whether Section 409A's rules apply to a particular arrangement.

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