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Client Alert

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Final Regulations under Section 409A – Important Issues for Stock Options and Other Stock Rights

This is one in a series of Client Alerts that the Latham & Watkins LLP Benefits and Compensation Group is issuing on the recent final regulations under Section 409A of the Internal Revenue Code regarding nonqualified deferred compensation. This Client Alert focuses on the impact of Section 409A on stock options and stock appreciation rights (collectively, "stock rights").

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Final Regulations Adopt Most Proposed Regulations

In general, the final regulations under Section 409A substantially adopt the rules and provisions set forth in the proposed regulations, with the following most notable additions, which are discussed below:

- Requirements for complying with the reasonable valuation presumption for "start up companies" are clarified;
- Arm's length sales in the same security are specifically referenced as factors to consider in valuing private company stock;
- Provisions allowing for the extension of the exercisability of stock rights are made more flexible; and
- Service recipient stock can now include stock of a subsidiary corporation.

FMV Stock Options and SARs are Exempt

As a threshold matter, the final regulations confirm that stock rights to purchase service recipient common stock (discussed below) are generally exempt from Section 409A if (i) the exercise price of the option or the base price for the stock appreciation right equals or exceeds the *fair market value* of the underlying stock on the date of grant and (ii) the stock rights have no other feature for the deferral of compensation. The final regulations treat stock appreciation rights similarly to stock options, regardless of whether the stock appreciation right is settled in cash and regardless of whether the stock appreciation right is based upon private company stock. Incentive stock options and employee stock purchase plans described in Section 423 of the Internal Revenue Code are not subject to Section 409A.

Valuation of Stock Remains Critical to Application of Section 409A

A stock right generally will constitute a deferred compensation arrangement subject to Section 409A if its exercise price is less than the fair market value of the underlying stock on the date of grant. The final regulations provide additional guidance for purposes of valuing stock in connection with setting stock right exercise prices.

Public Companies

The final regulations adopt the rules under the previously proposed Section 409A regulations regarding valuation of stock of public companies. The final regulations provide that with respect to public company stock, fair market value may be (i) based on 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) or any other reasonable basis using actual transactions in such stock as reported by such market and consistently applied.

The determination of fair market value also may be determined using an average selling price over a specified period that is within 30 days before or 30 days after the date of grant; provided that the commitment to grant the stock right is irrevocable before the beginning of the measurement period used to determine the exercise price and the valuation method is used consistently for similar grants).

The final regulations detail how "average selling price" is to be determined, but provide an exception to the rules where applicable foreign law requires that stock rights be priced based on a specific price averaging method and period. In such cases, a stock right granted in accordance with applicable foreign law will satisfy the final regulations provided that the averaging period does not exceed 30 days.

The final regulations' guidance is generally consistent with fair market value determinations by most public companies and should not result in a material change in option grant practices.

Private Companies

The final regulations provide that with respect to private company stock, fair market value must be "a value determined by the reasonable application of a reasonable valuation method." The determination whether a valuation method is reasonable, or whether an application of a valuation method is reasonable, is made based on the facts and circumstances as of the valuation date. The final regulations contain a list of factors to be considered in determining fair market value, as applicable:

i) the value of tangible and intangible assets of the corporation;
ii) the present value of anticipated future cash-flows of the corporation;
iii) the market value of stock or equity interests in similar corporations and other entities engaged in businesses substantially similar to those engaged by the corporation;
iv) recent arm's length transactions involving the sale or transfer of such stock or equity interests; and
v) other relevant factors, such as control premiums or minority discounts and whether the valuation method is used for other purposes having a material economic effect on the service recipient, its stockholders or its creditors.

References to preferred stock liquidation preferences are not included in the final regulations' non-exhaustive list of factors. However, the final regulations warn that a selected valuation method will not be deemed reasonable unless all available information material to the value of the corporation is considered. In addition, the use of a value previously calculated under a valuation method is not reasonable as of a later date if such calculation fails to reflect information available after the date of the calculation that may materially affect the value of the corporation. Examples include the resolution of material litigation or the issuance of a patent, or if the value was calculated with respect to a date that is more than 12 months earlier than the date for which the valuation is being used.

Presumptive Valuation Methods

The final regulations provide additional detail regarding presumptions with respect to the reasonableness of certain valuation methods. Such presumptions may be rebuttable only by a showing that the valuation method or its application was grossly unreasonable.

Independent Appraisal

A valuation determined by an independent appraisal that meets certain requirements of the Internal Revenue Code and which is dated no more than 12 months before the grant of the relevant stock right.

"Start-Up Company" Exception

For purposes of valuing the "illiquid stock of a start-up corporation" a valuation will be presumptively reasonable for a private corporation that has conducted business for less than 10 years if the valuation:

i) is evidenced by a written report;
ii) takes into account the valuation factors described above;
iii) is performed by a person that the corporation reasonably determines is qualified to perform such a valuation based on the person's "significant knowledge and experience or training;" and
iv) is made with respect to stock not subject to any put or call right, other than a right of first refusal and certain repurchase rights that arise in connection with a termination of employment.

For purposes of the above requirements, the final regulations clarify that a person will generally be qualified to perform the valuation if "a reasonable individual, upon being apprised of such knowledge, experience, education and training would rely on the advice of such person with respect to valuation in deciding whether to accept and offer to purchase or sell the stock being valued."

The final regulations provide that for purposes of this exception "significant experience" generally 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 service recipient operates.

The start-up corporation valuation method is *not* presumptively reasonable, however, if the corporation or optionee may reasonably anticipate, as of the time the valuation is applied, that the corporation will undergo a change in control within 90 days following the event to which the valuation is applied, or make a public offering of securities within the 180 days following the action to which the valuation is applied.

Formula Prices

A valuation of stock based on a formula that does not lapse or expire over time (for example, book value) will be presumed reasonable if used for all valuations of the stock, including regulatory filings, loan covenants and transactions involving the issuance or repurchase of the stock by the corporation or any person who owns more than 10 percent of the total combined voting power of all classes of the issuer's stock; provided, however, that this presumption of reasonableness does not apply with respect to an option exercisable for stock that can be transferred without regard to the formula price.

Stock Rights Generally may be Extended without Penalty

In general, the extension or renewal of a stock right will cause the stock right to be treated as having an additional deferral feature, and therefore be subject to and not compliant with Section 409A from the original date of grant of the stock right.

However, the final regulations provide, that it will not constitute an extension under Section 409A to extend the period of exercisability of (1) a stock right otherwise exempt from Section 409A that is extended before April 10, 2007 solely to provide the holder of the right an additional period of time beyond the stock right's original term or (2) a stock right otherwise exempt from Section 409A that is extended on or after April 10, 2007 if the extension is not beyond the *earlier* of the original expiration date on the stock right or the 10th anniversary of the stock right's date of grant.

Under the final regulations, it is not an extension for purposes of Section 409A if the exercise period of a stock right is extended while the stock right is "underwater" in that the exercise price of the stock right equals or exceeds the fair market value of the stock subject to the right at the time of the extension.

"Service Recipient" Stock Definition Expanded

In order to be exempt from Section 409A, a stock right must be exercisable for stock of the "service recipient." With respect to options granted after December 31, 2004, the final regulations define "service recipient" stock as common stock (within the meaning of Section 305 of the Internal Revenue Code) of the issuing corporation and any entities in which the issuing corporation owns at least a 50 percent interest (in value or voting power) for which the recipient of the stock right performs services. In limited circumstances, such as in a joint venture and other similar arrangements having a legitimate business purpose, the ownership interest can be as low as 20 percent.

The final regulations remedy concerns raised by the proposed regulations that common stock of a subsidiary corporation of a publicly traded corporation could not constitute "service recipient" stock. For example, under the final regulations, options to purchase stock of a majority owned subsidiary of a public corporation granted to employees of the subsidiary can be exempt from Section 409A.

The final regulations provide that service recipient stock does not include a class of stock that has any preference as to distributions other distributions of service recipient stock and distributions in liquidation of the issuer.

What Should Employers Do?

- Examine past and future option and stock appreciation right grant practices to confirm that stock rights are not being granted below fair market value.
- Evaluate whether stock rights are granted with respect to stock of the "service recipient."
- Employers who conclude that outstanding stock options are subject to Section 409A may take corrective action by December 31, 2007. However, some corrections to outstanding "discount" stock options had to have been made *before* December 31, 2006 and are not available in 2007 and beyond.

The final regulations are applicable for taxable years beginning on or after January 1, 2008. Taxpayers may rely on the provisions of these final regulations for taxable years beginning before January 1, 2008.

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