

Section 409A Creates Important Stock Option Issues

Section 409A of the Internal Revenue Code, enacted under the American Jobs Creation Act of 2004 (the "Act"), imposes sweeping new rules on deferred compensation arrangements maintained by employers. The Act significantly impacts equity compensation arrangements, including **stock options**, in addition to traditional deferred compensation plans. As a result, stock option issuers must be aware of the following:

- *"Discount" Stock Options Result in Adverse Tax Consequences.*

Nonstatutory stock options generally are taxable at the date of their exercise and not at their grant or vesting. The Act preserves this treatment for stock option grants to persons providing services to the issuer and certain subsidiaries, but only if the stock option is granted with an exercise price at or above the fair market value of the underlying stock on the date of grant. **A stock option granted with a per share exercise price that is less than the fair market value per share of a company's underlying stock on the date of grant is treated as deferred compensation under the Act. This will result in tax at vesting as opposed to exercise, as well as an additional 20% tax on the optionee,** unless the option provides by its terms that it is automatically exercised upon one or more permissible distribution events specifically enumerated in the Act (i.e., date(s) specified in advance; termination of employment; death; disability; unforeseeable financial emergency or a change in control).

The Act and prior law provide no definition of fair market value for purposes of stock option grants. Notice 2005-1 issued by the Internal Revenue Service and the Treasury Department states that fair market value may be determined by any reasonable valuation method but includes no guidance as to what constitutes a reasonable method to determine fair market value for purposes of stock option grants. Based on informal discussions with the Treasury Department, the use by public companies of the closing trading price on the grant date or the immediately preceding date to determine fair market value should comply with the Act. It is unclear whether the use of other methods, such as average closing prices over an extended period, is permissible.

Neither the Act nor informal discussions with the Treasury Department have yielded any guidance regarding acceptable methods for determining fair market value for a private company which are sure to comply with the Act. Neither the Act nor Notice 2005-1 address the determination of fair market value of common stock by reference to the terms of more senior securities (including a liquidation preference). Nor do the Act or Notice 2005-1 address the effect of taking a "cheap stock" compensation accounting charge.

Any nonstatutory stock option that was not fully vested as of December 31, 2004 is subject to the Act if granted with a below fair market value exercise price. "Incentive stock options" are exempted from the Act, as are rights under qualified employee stock purchase plans and restricted stock awards that do not provide for a deferral opportunity beyond vesting. Outstanding unvested stock options may be amended, cashed out or otherwise terminated, if necessary, to comply with the Act without penalty during a transition relief period ending December 31, 2005. Companies are subject to a "good faith" compliance standard with regard to stock option grants made during calendar year 2005.

We have discussed with Treasury Department officials the difficulties that private companies face as a result of the application of the Act to discount stock options and the absence of any guidance with regard to fair market value determinations. We are hopeful that additional clarity will be provided soon but urge private companies to exercise caution and seek guidance with regard to outstanding and future nonstatutory stock option grants.

- *Modifications of Outstanding Stock Options Must Be Reviewed.*

The Treasury Department has indicated informally that modifying any outstanding "in the money" stock option (whether an incentive or nonstatutory stock option) may cause that option to be treated as a newly issued discount stock option subject to the Act. The consequence of this is immediate

taxation, plus an additional 20% tax, for an optionee holding a vested option. A common modification this affects is the extension of the period of time that an optionee has to exercise his or her option following termination of employment. **This sort of modification arises often in the context of employee termination and severance negotiations. If an option is amended to extend its exercisability the amendment may be treated as a the grant of a new, discount, stock option that subjects its holder to immediate taxation, including an additional 20% tax, to the extent vested.** As a result of the foregoing, companies should seek guidance before any amendment to an outstanding option.

- *Possible Problem for Less than 80% Owned Subsidiaries.*

As indicated above, the Act preserves traditional tax treatment for nonstatutory options granted with a fair market value exercise price to persons providing services to the issuer and certain subsidiaries. In what appears to be a technical oversight, Notice 2005-1 limits the subsidiaries whose employees, consultants and directors may rely on this exception to subsidiaries of which the stock option issuer owns at least 80% of the outstanding voting power or value of the outstanding securities. Incentive stock options, in contrast, may be issued to employees of service providers of 50% owned subsidiary corporations. There does not appear to be any logical basis for the distinction between the treatment of nonstatutory options and incentive stock options granted to subsidiary employees under the Act and we have urged the Treasury Department to revise its guidance to make it clear that fair market value nonstatutory option grants to service providers of less than 80% owned subsidiaries are excluded from coverage under the Act.

The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact [Joseph Yaffe](#) in our Silicon Valley Office, any of the attorneys listed below or the attorney whom you normally consult.

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