What's News in Tax

Analysis that matters from Washington National Tax

Section 409A: Fifteen Years Later

Installment 2—Equity and Equity-Based Awards

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Fifteen years ago, a comprehensive set of rules and definitions restricting employers and employees in the design and modification of deferred compensation arrangements—section 409A—was enacted. Second in a series, this article focuses on how those rules apply to equity compensation.

Equity-based awards are a key component of most executive compensation packages. The type of award offered may be tailored to a variety of different objectives including attraction or retention of key employees as well as attainment of specific growth and financial goals.[1] Inherently tied to company performance, equity-based awards can serve to incentivize service providers to achieve strategic company objectives that will maximize company value by aligning the employee's interest with those of shareholders.

In addition to the business objectives, the tax implications, particularly under section 409A, may play a significant role in how equity-based awards are designed. As discussed in more detail below, equity-

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[1] Section 409A may apply to service providers which includes employees, independent contractors, and other service providers. This article uses the term "employee" for ease of reference. Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

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based awards take many forms and can vary widely in their terms and conditions. Whether awards are intended to comply with section 409A or meet the requirements of an exemption, both employers and employees should consider these rules in the design and operation of the award program. Even when properly designed, later action can invalidate an exemption or create a section 409A violation. Failing to adhere to the specifications of section 409A can result in significant additional taxes and penalties over the life of the award.[2]

Restricted Stock

Restricted stock generally includes the actual transfer of property, subject to a substantial risk of forfeiture ("SROF"), to an employee. Taxation of these awards is governed by property transfer rules under section 83. Property transferred in connection with the performance of services and taxable under section 83 is generally not deferred compensation within the purview of section 409A.

> The transfer of property, including **restricted stock awards**, does not fall within the purview of section 409A.
>
> *It is **critical to differentiate** between restricted stock and restricted stock units as they are governed by different rules and generally result in completely different tax treatment and considerations.*

In some cases, however, properly identifying whether there has been an actual transfer of restricted stock may be complicated. If stock awards are granted with special terms, conditions, and preferences it may alter the characterization of the award for U.S. tax purposes. Some examples in the international context (e.g., growth shares) are discussed under *Other Considerations* below.

Stock Options and Stock Appreciation Rights

A common form of equity-based compensation is a stock option, which entitles the recipient to exercise that option to purchase stock at an agreed upon price per share at a future date. Stock appreciation rights ("SARs"), on the other hand, generally entitle the recipient to cash (or stock, if stock-settled) equal to the increase in value of the underlying shares from the date of grant through the date of exercise.

Under section 409A as strictly written, options and SARs are basically the very definition of deferred compensation. Both paradigms provide for compensation that is earned and vested in one year and potentially paid several years later (hence a deferral from the year when earned). There is, however, an exception for such arrangements from the purview of section 409A within the regulations. This

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[2] The consequences for deferred compensation that is subject to section 409A, but does not comply with its rules, can be substantial. Noncompliant amounts are subject to immediate taxation at the time of vesting (rather than later distribution), and the recipient is subject to a 20 percent additional federal income tax as well as potential penalties and an interest-based tax calculated at the underpayment rate plus one percent. These consequences will continue to apply in subsequent tax years if the noncompliant amounts remain outstanding. State penalties may apply as well. Notably, California imposes an additional five percent tax (reduced from 20 percent for taxable years beginning before 2013).
For more background on the general application and operation of section 409A, please see "*Section 409A: Fifteen Years Later*," What's News in Tax (Nov. 11, 2019) available at https://home.kpmg/us/en/home/insights/2019/11/tnf-kpmg-report-section-409a-15-years-later.html.

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exception is subject to several terms and conditions. While an exemption exists for stock options and SARs, meeting the requirements for exemption is not guaranteed. Given their frequency, stock options and SARs are often assumed to be exempt from section 409A. However, whether the requirements of section 409A apply to a stock option or SAR, or consequences in the event of a failure to comply, often depends on various facts and circumstances set at the time of grant or changes made during operation of the plan. As such, thoughtful planning and consideration of these rules is an important step before and during the drafting of such plans as well as the ongoing plan implementation. It is a baseline best practice to at least annually review such arrangements for compliance as written and operationally.

Incentive Stock Options and Employee Stock Purchase Plan Options

So-called "statutory" stock options include incentive stock options ("ISOs") and options granted under an employee stock purchase plan ("ESPP"). There are specific requirements that plans must satisfy for options to qualify as ISOs and ESPPs.[3] If the detailed requirements are satisfied, there is no compensation at the time of exercise (although there may be an AMT adjustment required) for an ISO or exercise of a purchase right under an ESPP (except to the extent the shares are purchased at a discount). Further, if requisite holding periods are satisfied, then capital gain is recognized on a future disposition of the shares. ISOs and ESPPs are exempt from section 409A.[4]

Nonstatutory Stock Options

The most common type of option is the nonstatutory (also referred to as nonqualified) stock option ("NSO"), i.e., stock options that are not intended to or otherwise do not qualify as ISOs.

To satisfy the requirements for exemption from section 409A, an NSO must:

- Be granted over a fixed number of shares of service recipient stock;
- Be granted with an exercise price that is at least equal to the fair market value ("FMV") of the underlying stock on the date of grant;
- Be subject to taxation as an option under section 83; and
- Not include any additional deferral feature.[5]

> A nonqualified stock option must generally satisfy the requirements for exemption from section 409A as of the date the award is granted. The **date of grant** is therefore a critical reference point. An option is considered to be granted as of the date that all corporate actions necessary are taken.

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[3] A detailed discussion of ISOs and ESPPs is outside the scope of this article. For more information regarding ISOs and ESPPs, see sections 422 and 423, as well as the regulations promulgated thereunder. There are many requirements to consider in establishing, documenting, and operating an ISO arrangement or an ESPP. Consult with a tax professional to understand these rules and their tax implications, and to determine what programs make the most sense for your business.

[4] Section 1.409A-1(b)(5)(ii).

[5] Section 1.409A-1(b)(5)(i)(A).

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Service Recipient Stock

The first requirement is frequently overlooked. Service recipient stock means common stock with no preference as to distributions (other than on liquidation) or stock subject to either a mandatory repurchase obligation or a put or call right at a price other than FMV. Service recipient stock may include American depositary receipts or mutual company units. This term only includes stock of the entity directly receiving the services of the employee or contractor on the date of grant, or any corporation in a chain of corporations or other entities in which each has a controlling interest *ending* with the entity receiving the services. A controlling interest for this purpose generally refers to at least 50 percent ownership, but may be as low as 20 percent in limited circumstances. Note that brother/sister companies typically do not satisfy this rule as they may share the same parent, but one does not control or own the other.

> *Example*—Company A is owned by HoldCo and has multiple wholly owned subsidiaries, including a newly prospering business in Sub B. Expecting future growth in the value of Sub B, Company A issues options to purchase units of Sub B to various Sub B employees as well as a handful of Company A officers who provided some services to Sub B at its inception but no longer provide any services to Sub B.
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> The Sub B options to the Company A officers are not granted over "service recipient stock" for section 409A purposes because it is not stock of the entity receiving the officers' services as of the date of grant or another controlling entity up the chain. Alternatively, if the options were granted over stock of HoldCo, then the stock would be service recipient stock.

Fair Market Value

Setting the exercise price at or greater than the FMV of the underlying shares is the most common area for unintentional failure to satisfy the section 409A exemption requirements. A "discounted option"—one with an exercise price lower than the FMV of the stock underlying the option as of the date of grant—does not satisfy the stock right exemption from section 409A. How the FMV of underlying shares is determined for section 409A purposes depends on whether the stock is readily tradable on an established securities market.

If the underlying stock is readily tradable (in other words, publicly traded), the FMV can be determined using any reasonable method that uses actual transactions of that stock in the market. Under section 409A, the FMV may be determined by:

- The last sale before or first sale after grant of the option;
- The closing price on the trading day before or trading day after grant;
- The arithmetic mean of the high and low prices on the trading day before or the trading day of the grant; or
- Using an average selling price during a specified period within 30 days before or 30 days after the applicable valuation date (this method must generally be stated in the plan and the details specified prior to the start of the averaging period).

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Example – Company L is a public company with a stock option plan that specifies that the exercise price of all options will be equal to the closing price on the last trading day before the date of grant. Company L consistently applies this step when granting stock options under the plan.

If the underlying stock is not readily tradable, the FMV as of a given date must be determined by "the reasonable application of a reasonable valuation method."[6] Reasonableness is determined based on all relevant facts and circumstances at the time of the valuation date; a method is not deemed to be reasonable if it does not consider all available material information. The regulations provide a list of factors that may be applicable to the valuation, such as the value of assets of the corporation, the present value of anticipated future cash-flows, and recent arm's length transactions. The use of a valuation method is not reasonable if the valuation is more than 12 months old or new information is available (such as issuance of a patent) that materially affects the valuation of the corporation. A "stale" valuation may be a source of potential exposure when considering whether stock options fit within the exemption.

It is important to remember that not all valuations are performed with **section 409A FMV** requirements and definitions in mind, especially those performed outside of the U.S.

There are certain safe harbors that are presumed reasonable for purposes of determining the FMV of the corporation. If one of these safe harbors is satisfied, then the burden is on the Internal Revenue Service ("IRS") to prove that reliance on such safe harbor methods was grossly unreasonable in a particular instance. These safe harbors for valuation include the following:

– *Independent valuation*: An independent valuation that meets the requirements for valuing stock held by an employee stock ownership plan and that was issued no more than 12 months before the grant date is presumed reasonable.

– *Illiquid start-up*: For illiquid stock of a start-up company, a reasonable, good faith valuation evidenced by a written report issued by a qualified individual is presumed reasonable.

– *Binding formula*: A binding formula exists when there is the consistent application of a single formula and used for a binding agreement, i.e. buy-sell agreement, both for grant of stock and options, purchases or sales of stock to third parties, etc.

The most common approach to achieving 409A safe harbor status is an independent valuation through a third-party appraiser. We also will see the illiquid startup approach when the valuation is performed by someone in-house with the requisite skill set and experiences, but the skill set and experiences can sometimes present an issue. Although a valuation is not required, it is often recommended to mitigate the risk that the exercise price is viewed as less than FMV by the IRS or against potential issues in a corporate transaction such as a merger, investment, or public offering.

[6] Section 1.409A-1(b)(5)(iv)(B).

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> *Example* – Company M is a private company that obtains an independent annual valuation based on the section 409A rules for determining FMV. Company M is preparing to grant options to a number of employees and plans to set the exercise price equal to the FMV of its stock based on the most recent valuation as of six months ago. However, Company M is currently in negotiations to be acquired and it is anticipated that the acquisition will materially increase the stock value when announced. *Is the most recent valuation still a reliable tool to determine FMV of the stock for purposes of section 409A?*

Finally, the binding formula safe harbor is rarely utilized due to the limitations on third-party transactions, etc.

No Additional Deferral Feature

To fall within the stock right exemption from section 409A, a stock option or SAR may not have any additional deferral feature (i.e., the ability to defer compensation after income recognition is triggered by exercise). Notably, this does not include a situation in which unvested shares are received on exercise and compensation recognition is deferred until the SROF lapses. The compensation event cannot be deferred beyond the later of: (1) the exercise or disposition of the option; and (2) the time the shares acquired pursuant to exercise first become substantially vested.

Stock Appreciation Rights

For section 409A purposes, SARs are treated similarly to NSOs and have similar requirements for exemption.[7] As an initial matter, they must be over a specified number of shares of service recipient stock, with an exercise price at least equal to the FMV of underlying stock on the date of grant, and may not have an additional deferral feature (as described above).

The exercise price and compensation payable restrictions achieve a similar result to that of NSOs, but is articulated in a slightly different way. To be exempt, a SAR may not pay out compensation in an amount that is greater than the excess of the FMV of the stock on the date the SAR is exercised over the exercise price.

> Consideration of dividends or other distributions is often necessary in plan design. The right to receive full or partial **dividends or other distributions** that are contingent, directly or indirectly, on the exercise of a stock right may be treated as an offset to the exercise price of an option or increase in amount payable under a SAR. This right may cause the stock right to be subject to section 409A (i.e., to fail to satisfy the requirements for exemption as a stock option or SAR).
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> To the extent these awards are not contingent on exercise of the stock right, the dividend equivalent or distribution may itself be deferred compensation subject to section 409A without invalidating the exception for the related stock option or SAR.

[7] Section 1.409A-1(b)(5)(i)(B).

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Modifications, Extension, Substitutions, and Assumptions

Later modifications of an exempt or compliant equity award can jeopardize its section 409A status. Careful review of any proposed changes is often an important step before any changes are actually made.

Under section 409A, a **modification** of a stock option or SAR is generally treated as the grant of a new award that must meet all requirements as of the grant date of the new award. In other words, for the modified option or SAR to be exempt, the exercise price must be equal to or greater than the FMV of the underlying stock on the date of the modification. An award is considered modified for this purpose if there is any change in its terms that directly or indirectly reduces the exercise price, regardless of whether the award holder actually benefits from that change.

When the term of a stock option or SAR is **extended**, it is generally treated as having an additional deferral feature from its original date of grant. In other words, the original option or SAR is treated as deferred compensation subject to section 409A. To the extent the original option or SAR is not compliant with section 409A, then there is a failure triggering tax under section 409A. There are limited exceptions on the ability to extend an option (e.g., underwater options) and, in some situations, the extension is treated as a modification (i.e., grant of a new award).

In a corporate transaction, stock awards are often **substituted** or **assumed**. When carried out in line with specified requirements (generally preserving the economics of the award), the substitution or assumption is not treated as a modification or a change in the time or form of payment under section 409A. Substitutions and assumptions in a corporate transaction can be structured to maintain the award's exemption or compliance, but the parties must adhere closely to the procedures provided under section 409A. These and other considerations related to section 409A in mergers and acquisitions will be addressed in a future article.

Other Means of Exemption and Compliance

Stock options and SARs may be designed to be exempt under other section 409A rules. For example, the arrangement may provide an automatic exercise provision within the short-term deferral period (generally, shortly following the lapse of any SROF). Alternatively, awards may be structured to comply with section 409A by limiting exercise to permissible payment events (e.g., separation from service, change in control, or a specified year). However, a compliant section 409A plan for options and/or SARs generally eliminates the ability to exercise the award at any time and may be considered an unattractive approach.

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Restricted Stock Units

Restricted stock units ("RSUs") or phantom equity awards do not reflect a section 83 transfer of property on grant. Instead, they represent a mere promise to pay shares or cash in the future. As such, RSUs may be considered deferred compensation that falls squarely within the reach of section 409A.

Under some RSU plans, participants have the opportunity to receive additional compensation in the form of **dividend equivalents**. Dividend equivalents generally mirror the dividend payments made to shareholders. Dividend equivalents are treated as additional compensation—not dividends—for tax purposes.

Plans are often drafted so that either:

1. Dividend equivalents are paid shortly following the time a dividend is declared (such that they are not deferring compensation into a later year); or
2. The dividend equivalents are subject to the same vesting and payment schedule as the underlying RSU award (such that they are compliant with or exempt from section 409A).

A common approach to address potential section 409A application to RSUs is to design the awards to be exempt from section 409A from the outset. This is often accomplished by providing that the RSUs will be settled within a short window after vesting (e.g., within 30 days), but in any event within the short-term deferral time period.[8] In drafting an RSU plan to fit within the short-term deferral exemption, employers may need to consider whether any events may occur prior to the normal vesting schedule that would result in vesting of the RSU (e.g., reaching retirement age [a common feature in many public company arrangements]) and ensure that timely payment is made in those circumstances under the plan rules.

RSUs that are not exempt must be structured to comply with the requirements of section 409A. A key component is to ensure that the settlement of awards is limited to section 409A permissible payment events. Additionally, the distribution schedule—both the time and form of payment—should be identified up front. The distribution schedule may be prescribed by the employer under the plan terms or in the award agreement. Alternatively, the employer may permit employees to elect the time and form of payment.

As discussed in more detail in *Section 409A: Fifteen Years Later*, awards may be further deferred into the future if certain requirements are met, but payment can very rarely be accelerated outside of the terms in place at the grant of the award.

Other Considerations

Equity-based arrangements that originate outside the United States often present additional complication from a section 409A perspective if they are granted to U.S. taxpayers (generally, this includes citizens and residents as well as non-residents with U.S. services during the grant to vest

[8] Payments may generally qualify as a short-term deferral – and thus not be considered a deferral of compensation subject to section 409A—if actually or constructively received within 2½ months following the end of the tax year in which the SROF lapses and there is no plan provision allowing payment at a later date. The applicable tax year is the service recipient or service provider's—whichever would create a longer short-term deferral period. The time frame in which the payment must be made is often referred to as the "short-term deferral period."

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period). Awards are often designed to satisfy non-U.S. legal or tax requirements and may not be established with section 409A in mind. For example, stock options issued by a non-U.S. company may be intentionally granted at a discount. For stock options granted by a private non-U.S. company, there may be no valuation done, a stale valuation, or insufficient information to determine how the exercise price was set.

In addition, a non-U.S. private company may award "growth shares" to management or key employees. Generally, growth shares are awards over a certain class of stock subject to a hurdle before the recipient participates in company growth. Alternatively, a non-U.S. private company may grant a class of shares subject to a hurdle, with limited dividend or voting rights, with the potential to convert into a different class of shares. These awards may be considered equity grants in the local tax jurisdiction but often require additional consideration under U.S. tax rules. Depending on the particular award, it is possible that these awards may be considered restricted stock exempt from section 409A as a property transfer subject to section 83.

A review of a non-U.S. equity-based arrangement is often recommended to understand the section 409A application, as well as amend the plan, before awards are granted to U.S. taxpayers or before an existing participant becomes a U.S. taxpayer. In practice, some non-U.S. employers may be resistant to a U.S. plan review or amendment to address section 409A rules due to a small U.S. employee population, cost, or perceived difficulty in plan administration if there will be special rules for U.S. versus non-U.S. participants.

Coming up…

Preparing for a corporate transaction gives rise to potential section 409A issues. Uncovering and quantifying exposure related to potential section 409A failures composes a sizeable portion of the compensation and benefits tax due diligence process. In addition, planning for the effect of the merger on various compensation items, including equity awards and transaction-based compensation, should include careful consideration of the section 409A rules. Strategies to achieve the parties' objectives while maintaining compliance with (or exemption from) section 409A, as well as how to correct and move forward from historical failures are critical components of a smooth and successful transaction. For more details on common missteps, applicable rules, and planning considerations in the transaction context, stay tuned for the next installment in our *Section 409A: Fifteen Years Later* series.

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