



New IRS Deferred Compensation Rules Impact §409A Compliance Dates

By Garry J. Schnell

Section 409A of the Internal Revenue Code made significant changes to the tax rules applicable to nonqualified deferred compensation and imposes strict new requirements regarding the design, funding and operation of such plans or arrangements. The new rules are technically effective for tax years beginning on or after January 1, 2005 but there have been various incremental transitional allowances that extend to the end of 1007. If a plan or arrangement fails to comply with the new rules by the various transition dates, the recipient of any vested deferred compensation will be subject to immediate taxation on the value of the deferred compensation, plus an additional 20% income tax "penalty" and potential interest. It is important to note that a faulty deferred compensation program will affect the company's withholding obligations that could result in personal liability of corporate officers.

Broad Application of 409A

The application of Section 409A is wide-ranging. Nonqualified deferred compensation plans include any plan, arrangement or agreement that provides for the deferral of compensation, other than pursuant to a qualified employer plan (e.g., an employer's 401(k) or any bona fide vacation, leave, sick leave, compensatory time, disability pay or death benefit plan. A plan can be a one-time arrangement or a "plan" that covers all employees for their entire employment, or almost any company practice or procedure in between. Severance and separation payment arrangements, bonus awards, performance based compensation, certain reimbursement policies, split-dollar insurance arrangements and noncompetition agreements are all now also subject to 409A compliance.

As discussed below, most notable for our clients is the application of Section 409A to stock options and other formal

stock appreciation plans or arrangements. Section 409A applies to stock options granted at less than 100% of fair market value ("FMV") or options that contain elective deferral of income features. Restricted stock that provides for deferral after vesting and restricted stock units where the stockholder controls the payment date can also fall within Section 409A

Fair Market Value

A central issue Under Section 409A is the concept of fair market value. Whether it is in connection with the granting of stock options or other equity-based compensation arrangements, the new law puts a company's ability to set the strike price for these types of options or the purchase price for restricted stock under a microscope. Under the new law, the "ack of the envelope" approach in which the IRS previously would give the company significant good faith leeway in making the FMV determination of its securities will no longer be allowed.

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The new valuation requirements under Section 409A mandate a more formal approach to determining the fair market value of affected securities (essentially the company's "common stock"). For the start-up company, the situation is even more difficult because there is no readily tradable market that can be used as a reference. A "reasonable" valuation method must be used for securities that are not readily tradable on an established securities market and such valuation method must be consistently applied.

Unfortunately, the IRS' approved valuation methods are very cumbersome for most nonpublic companies. However, if an acceptable valuation process is not followed, the securities could be considered as issued at "below market" and become subject to the very significant penalties of 409A. While various valuation procedures might ultimately pass IRS muster,

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the process, as currently outlined in the proposed regulations to Section 409A, is far more complicated than previous approaches and it would be imprudent to ignore its application or implications.

Option Plans

Any company that currently maintains a plan that provides for the issuance of stock options (whether incentive stock options "ISOs"), non-qualified stock options or both), will likely require amendments to its plan, as well as additional administrative guidance to ensure Section 409A compliance. ISOs are technically not subject to 409A since the option strike price must be at least equal to FMV of the stock subject to the option. However, practitioners expect that the method by which a company sets the FMV exercise price will be subject to the higher scrutiny of Section 409A valuation requirements.

Nonqualified options have frequently been issued at below FMV in the past and are thus currently in violation of 409A but subject to a remedial period, in most cases, to the end of 2007.

However, any plan maintained by a public company that currently has existing nonqualified stock options or plans of public or private companies that had non-qualified stock options exercised after January 1, 2005 need to be reviewed

and remedial action taken before the end of this year. The practice of issuing nonqualified stock options with a strike price less than FMV is now absolutely prohibited.

If you have a question about how _____ affects your business, please contact us.



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