409A and Valuations for Equity Awards

Internal Revenue Code Section 409A regulates "nonqualified deferred compensation" and imposes severe tax penalties on the employee if violations occur. Generally, 409A regulates compliance of nonqualified deferred compensation plan regarding the timing of deferrals and distributions.

Noncompliance results in all amounts deferred under the plan for the current year and all previous years becoming immediately taxable, plus a 20% penalty tax, to the extent the compensation is not subject to a "substantial risk of forfeiture" and has not previously been included in gross income.

409A Applications 409A covers nonqualified deferred compensation plans, employment agreements, severance arrangements, changes in control payments and any other arrangements that result in deferral of compensation. Restricted stock units and phantom equity awards must also meet 409A rules. Basically, 409A applies to any legally binding right to compensation for services that will be paid in a later year.

There are various exceptions, including qualified plans like pension and 401(k) plans, and welfare benefits including vacation leave, sick leave, disability pay or death benefit plan. Other exceptions include those for short-term deferrals (defined as payments made within two-and-one-half months of the year in which the deferred compensation is no longer subject to a substantial risk of forfeiture), certain stock option and stock appreciation rights and certain separation pay plans.

In addition to the previous exemptions, nonqualified stock options and stock appreciation rights are exempt provided that:

- The option or right is for common stock, *and*
- The exercise price is at least equal to the fair market value of the underlying stock.

409A Regulations Distributions under a nonqualified deferred compensation plan can only be payable upon one of six circumstances:

1. The employee separating from service
2. The employee becoming disabled
3. The employee's death
4. A fixed time or schedule specified under the plan
5. A change in ownership or effective control of the corporation, or a change in the ownership of a substantial portion of the assets of the corporation
6. An unforeseen emergency

In addition, special timing rules apply to "key employees" of publicly traded corporations; distributions upon separation must be delayed by an additional six months following separation (or death, if earlier).

As a general rule, initial deferral elections must be made no later than the close of the employee's taxable year immediately preceding the service year. The term "initial deferral elections" includes all decisions, whether made by the employee or employer, as to the time or form of payment under the plan. Once the initial deferral election is made, a change to the time or form of payment under the plan can only be made under the rules governing subsequent deferral elections.

EXAMPLES Here are two examples of deferred compensation disbursements, one favorable and one unfavorable.

Favorable scenario: An employee has the right to receive $100,000 if he is still employed when he reaches age 60 or, if earlier, within two-and-one-half months after the end of the year in which the company has a successful initial public offering. Even though an IPO is not a permissible payment event, in this case the right to receive the compensation will only vest when the IPO occurs or the person attains age 60 and will be paid promptly upon the event occurring, creating a short-term deferral to which Section 409A does not apply.

Unfavorable scenario: An executive aged 60 in January 2013 is awarded a vested right to receive $100,000 upon the earlier of separation from service or attainment of age 65. Even if separation and payment occur in December 2013, this is not a short-term deferral because the amount could have been paid outside the two-and-one-half months (i.e., if the six-month waiting period for a key employee applies).

VALUATIONS OF 409A AWARDS Deferred compensation is frequently in the form of stock options that meet the "high risk of forfeiture" qualification. In order to be exempt from 409A rules, they must have an exercise price at least equal to fair market value, as well as meet certain other requirements. The fair market value requirement means that the stock needs to undergo a valuation annually.

An appropriate appraiser will consider such factors as:

- Prior transactions in the company's stock
- Historical profits, cash flow and liabilities
- The value of tangible and intangible assets
- The net present value of future cash flows
- The market value of similar businesses
- Discounts for lack of marketability
- The company's use of the same method for other material purposes

Valuations must be prepared by a person (can be an employee) with 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 line with the business or industry of the company. However, using a third-party, independent appraiser will provide a "safe harbor" should the valuation be challenged.

Contact Mike Dorman at 847-205-5000 for more information.