



# Equity Pitfalls Under Section 409A Checklist

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A Checklist of common pitfalls that may cause restricted stock units and stock options to violate Section 409A of the Internal Revenue Code and methods of avoiding these pitfalls.

Section 409A of the Internal Revenue Code (IRC) provides a comprehensive set of rules regulating the taxation of nonqualified deferred compensation. If an equity award violates Section 409A, the award may become immediately taxable and the award holder will incur an additional 20% penalty tax and potential interest penalties. This Checklist highlights potential pitfalls under Section 409A that can arise when granting and administering restricted stock units (RSUs) and stock options and the methods for avoiding these pitfalls.

For an overview of the application of Section 409A to equity awards, see *Practice Note, Section 409A: Deferred Compensation Tax Rules: Overview: Share Equity Plans* (<http://us.practicallaw.com/6-501-2009>).

## ISSUES WITH RESTRICTED STOCK UNITS

The following issues may arise when granting and administering RSUs.

### Issue One: RSUs Are Inadvertently Structured as Deferred Compensation Subject to Section 409A

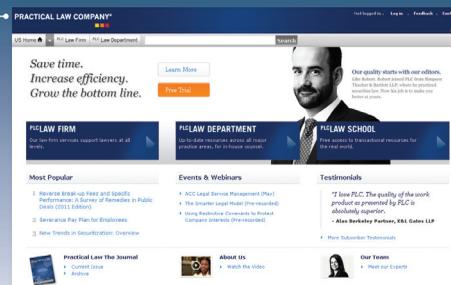
#### The Pitfall

Of the common types of equity awards, RSUs are the most likely to be subject to Section 409A.

An RSU that appears to be excluded from Section 409A as a short-term deferral because it generally pays on vesting may in fact be subject to Section 409A if vesting of the RSU:

- Accelerates when the employee retires.
- Accelerates when the employee voluntarily terminates his employment for good reason and the definition of “good reason” does not meet the Section 409A standard for treatment as an involuntary termination of employment (for example, because good reason includes the right to terminate employment for any reason on a change in control or on non-material changes in employment terms).

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- Continues for a period following retirement or other termination of employment, including during a post-termination non-competes period.

#### Why It Is a Potential Problem

There is much less flexibility in granting and amending an RSU that is subject to Section 409A because of the requirements of Section 409A, including:

- The RSU must have a fixed payment date or fixed payment schedule that complies with Section 409A.
- Payment dates based on events, including a change in control or an employee's disability, must be defined consistently with Section 409A.
- Except for limited circumstances, only vesting, and not payment, of the RSU can be accelerated.
- If a key employee of a public company (a specified employee) has an RSU that is payable on his termination of employment, the RSU must provide for a six-month payment delay following the employee's termination of employment. For more information on the six-month payment delay, see *Practice Note, Section 409A: Deferred Compensation Tax Rules: Overview: Mandatory Six-month Delay For Payment To A Specified Employee* (<http://us.practicallaw.com/6-501-2009>).

If an employer incorrectly treats an RSU as excluded from Section 409A and takes actions that violate Section 409A (for example, accelerating payment) or the RSU fails to satisfy applicable Section 409A documentary requirements, the employee will incur the negative tax consequences under Section 409A.

#### How to Avoid This Pitfall

Review all documents related to an RSU award, including employment, severance and change in control agreements. Provisions that cause an RSU to become subject to Section 409A are frequently in documents other than the equity plan

and RSU agreements (for example, employment agreements or severance agreements).

**Short-term Deferral.** Structure the RSU as a short-term deferral so that it is not subject to Section 409A by:

- Providing for vesting only on completion of substantial service requirements or on an involuntary termination of employment (including limited “good reason” terminations that are consistent with the Section 409A standards for treatment as an involuntary termination of employment).
- Eliminating vesting on retirement or providing that the RSU will be paid when the employee becomes **eligible for retirement**, rather than when the employee actually **retires**.
- Including a claw back on non-compliance with restrictive covenants, rather than providing for vesting over the restricted period.

**RSUs Subject to Section 409A.** If the RSU contains a provision that causes it to be subject to Section 409A:

- Designate a fixed payment date or fixed payment schedule.
- Do not accelerate payment on impermissible events.
- Provide for payment only on a Section 409A-compliant change in control or disability if change in control or disability is an intended payment event.
- Include a six-month delay for payment to a specified employee if the RSU is payable on the specified employee’s termination of employment.

### Issue Two: Time and Form of Payment of RSUs in Connection with Termination of Employment

#### The Pitfall

An employer wants to grant an RSU that has a different payment form or schedule on termination, depending on why the employee terminates employment.

For example, the RSU agreement provides that if the employee:

- Terminates his employment voluntarily, RSUs are paid on the first anniversary of termination.
- Terminates his employment involuntarily, RSUs are paid immediately on termination.

#### Why It Is a Potential Problem

Under Section 409A, subject to limited exceptions, payments must have one payment schedule for any single payment event. This generally requires that a payment made on various types of employment terminations be paid on the same schedule, regardless of what type of termination occurs.

RSUs that are subject to Section 409A must comply with this rule.

#### How to Avoid This Pitfall

**Short-term Deferral.** Structure the RSU so that it pays on vesting and is a short-term deferral that is not subject to Section 409A (see *Issue One: RSUs Are Structured as Deferred Compensation Subject to Section 409A: How to Avoid This Pitfall*). In this case, although

payment may be made in a different form on different types of terminations, payment must in all events be completed on or before the applicable short-term deferral date following vesting (usually, March 15 of the year following the year of termination).

**RSUs Subject to Section 409A.** There are several ways to structure the RSU so that it complies with Section 409A:

- Structure the RSU to comply with one of the following exceptions that permit a different payment schedule if termination of employment occurs under specific circumstances:
  - termination within two years following a 409A-compliant change in control; or
  - termination following a specified date, specified number of years of service or combination of a specified date and number of years of service (for example, payment in a lump sum if termination occurs before the employee has reached age 55 with 15 years of service and installments if termination occurs on or after the date the employee has reached age 55 with 15 years of service).
- Structure the RSU so that payment is made on only certain types of terminations. For example, an agreement can provide that payment will be made on the earlier of an involuntary termination of employment and the employee’s 65th birthday and that if the employee voluntarily terminates employment before age 65, the payment is forfeited. Another alternative is to provide that under these circumstances, if the employee voluntarily terminates employment before age 65, the payment date will be his 65th birthday. This alternative is not clearly permitted under Section 409A, but the IRS has stated informally that it would approve of this approach.
- Structure the RSU to provide for different payment schedules based on which 409A-compliant payment event occurs. For example, provide differing payment schedules for each of the following events:
  - the employee’s death;
  - the employee’s 409A-compliant disability; and
  - any other termination of employment.

### Issue Three: Payment of an RSU on or Following Termination of Employment Requires Execution of a Release of Claims

#### The Pitfall

An employment or severance agreement provides that an RSU payable on termination of employment will not be paid until the employee signs and does not revoke a release of claims against the employer.

#### Why It Is a Potential Problem

**Short-term Deferral.** For RSUs intended to be short-term deferrals, if either of the following occurs, the RSU will not be paid in time to be a short-term deferral:

- The employee does not sign the release by the short-term deferral date applicable to the employer and employee (usually, March 15 of the year following the year of termination).



- The release revocation period does not end by the short-term deferral date.

If an employer does not pay the RSU on or before the short-term deferral date, it may cause a violation of Section 409A.

**RSUs Subject to Section 409A.** For RSUs intended to be subject to Section 409A and to comply with Section 409A, the employee's ability to delay payment of the RSU by delaying execution of the release could also create a problem. Depending on how long the employee waits to sign the release, there may be an impermissible payment delay that violates Section 409A. In addition, the IRS appeared to suggest in its published corrections procedures for documentary violations under Section 409A that this type of delay may result in a documentary violation of Section 409A.

#### How to Avoid This Pitfall

**Short-term Deferral.** When the RSU is intended to be a short-term deferral, draft the RSU agreement and pay the RSU consistent with each of the following:

- Provide that payment will be made after execution of the release and termination of any revocation period.
- Include the maximum number of days following termination of employment that the employee has to execute the release. In calculating the maximum, consider any legally required periods that must be provided to the employee for consideration and revocation of the release.
- Require that the employee forfeits his right to payment if the release is not executed within the maximum number of days.
- The sum of the following should not exceed 74 (corresponding to the earliest possible two-and-a-half month short-term deferral deadline):
  - the number of days following termination of employment that the employee has to execute the release; and
  - the number of days during the period beginning on the date the release is executed and ending on the payment date.

**RSUs Subject to Section 409A.** When the RSU is intended to be subject to Section 409A, draft the RSU agreement and pay the RSU consistent with each of the following:

- Specify the date on which payment will be made (for example, the 60th day following termination of employment). In specifying the payment date, consider any legally required periods that must be provided to the employee for consideration and revocation of the release.
- Require that the employee forfeits his right to payment if the release is not executed and effective by the specified payment date.
- Pay amounts on the specified payment date.

## ISSUES WITH STOCK OPTIONS

The following issues may arise when granting and administering stock options.

### Issue One: Ways to Measure Fair Market Value for Purposes of Setting the Exercise Price of a Stock Option Granted by a Publicly Traded Company

#### The Pitfall

A publicly traded company wants to grant stock options with an exercise price based on the average trading price over a specified period (for example, 30 days).

#### Why It Is a Potential Problem

For a stock option to be structured so that it is excluded from Section 409A, it must satisfy certain requirements, including that the exercise price is no less than fair market value on the grant date. Section 409A permits fair market value to be measured based on an average trading price over a specified period only if certain conditions are met, including the:

- Period cannot extend more than 30 days before or 30 days after the grant date.
- Recipient of each stock option and the number of shares subject to each stock option must be identified before the beginning of the exercise price measurement period.
- Commitment to measure fair market value based on the average trading price during the specified period must be irrevocable before the beginning of the period.

#### How to Avoid This Pitfall

Implement grant procedures that ensure satisfaction of all of the requirements for granting stock options with an exercise price based on the average trading price over a specified period.

An alternative measure of fair market value can also be used including the:

- Closing price on the grant date.
- Closing price on the day preceding the grant date.
- Mean of the high and low trading prices on the grant date.
- Mean of the high and low trading prices on the day preceding the grant date.

### Issue Two: Ways to Measure Fair Market Value for Purposes of Setting the Exercise Price of a Stock Option Granted by a Private Company

#### The Pitfall

A private company wants to grant stock options with an exercise price at least equal to fair market value on the date of grant, so that the stock options are excluded from Section 409A. However, the methods and standards for valuing private company stock to determine fair market value under Section 409A are vague.

#### Why It Is a Potential Problem

When valuing private company stock under Section 409A, fair market value must be based on a:

- Reasonable application of a reasonable valuation method.
- Valuation that is no more than 12 months old, but should be

based on a more recent valuation if it would otherwise fail to reflect new information materially affecting the value of the company (for example, resolution of a material litigation or issuance of a patent).

### How to Avoid This Pitfall

Use one of the safe harbor methods such as an independent appraisal, a non-lapse restriction valuation or a start-up company valuation. If not using one of the safe harbor methods, then use an alternative valuation method that satisfies the reasonableness standards. For more information on the safe harbor methods and considerations in satisfying the reasonableness standards, see *Practice Note, Determining Fair Market Value of Equity Awards Under Section 409A* (<http://us.practicallaw.com/1-502-0926>).

## Issue Three: Modification of a Previously Granted Stock Option

### The Pitfall

An employer grants a stock option that is structured to be excluded from Section 409A and then the employer modifies the stock option. The modification directly or indirectly reduces the exercise price of the stock option or extends the term of the stock option.

### Why It Is a Potential Problem

The modification or extension of an otherwise excluded stock option may cause the stock option to become subject to Section 409A.

Because stock options by their terms may be exercised over the course of multiple years at the discretion of the option holder, they generally violate Section 409A once they inadvertently become subject to Section 409A.

The following modifications can cause a previously granted excluded stock option **to become subject to Section 409A**:

- Repricing a stock option that has an exercise price that is less than fair market value at the time of repricing (an in-the-money option).
- Extending the term of an in-the-money option beyond the shorter of:
  - the original expiration date; and
  - ten years from the grant date.
- Providing for deferral of stock option gains or deferred payment of an exercised stock option or stock appreciation right.

The following modifications **will not cause** a previously granted excluded stock option to become subject to Section 409A:

- Shortening the term of the stock option.
- Adding cashless exercise or cash-out features.
- Accelerating or delaying the vesting of the stock option.
- Extending the post-termination exercise period, but not beyond the shorter of:
  - the original expiration date; and
  - ten years from the grant date.
- Proportionately adjusting the stock option to reflect a stock split or corporate transaction.

- Tolling the term of a stock option while the exercise of the stock option would violate law or would jeopardize the employer's ability to continue as a going concern.
- Permitting a transfer of stock options without consideration.

### How to Avoid This Pitfall

If an impermissible change is made, the change may be rescinded before the last day of the calendar year in which the change is made (or, if earlier, the date the stock option is exercised).

Modifications reducing exercise price and extensions are generally permissible for stock options that have an exercise price that is greater than or equal to fair market value (out-of-the-money options). However, because any modified stock option will be treated as a new grant under Section 409A, the new exercise price must be no less than the fair market value of the employer's stock on the date of the modification.

## Issue Four: Dividend Equivalent Rights Granted on Stock Options

### The Pitfall

An employer wants to grant dividend equivalent rights on a stock option and wants to require that once the stock option is exercised and the employee is a stockholder, the dividend equivalent rights terminate.

### Why It Is a Potential Problem

Because the dividend equivalent rights terminate when the stock option is exercised, they may be viewed as an indirect reduction in option exercise price. This causes a stock option that is not otherwise subject to Section 409A to become subject to Section 409A. If a stock option is subject to Section 409A, it loses much of its flexibility and requires, among other things, a fixed payment date.

### How to Avoid This Pitfall

Structure the dividend equivalent rights so that they terminate on **vesting** of the underlying stock option, rather than on **exercise** of the underlying stock option.

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