

January 4, 2006

Stock Valuation Guidance and Section 409A Technical Corrections

The Internal Revenue Service (the "Service") and Congress were busy in December. The Service issued additional guidance on section 409A of the Internal Revenue Code of 1986, as amended (the "Code") and Congress enacted the Gulf Opportunity Zone Act of 2005 ("GOZA"). Both impact deferred compensation arrangements under Code section 409A ("409A").

IRS Notice 2006-4. Nonqualified stock options ("NQSOs") and stock appreciation rights ("SARs") (referred to collectively or individually as "stock rights") are excepted from the requirements of 409A, so long as the exercise price can never be less than the fair market value of the underlying stock on the grant date, and the stock rights do not include any additional deferral features. (Incentive stock options also are not treated as deferred compensation covered by 409A and, as noted below, have their own rules for determining fair market value.)

Under Notice 2005-1 issued by the Service early in 2005, *any reasonable valuation method* may be used to determine the fair market value of the underlying stock for NQSO and SAR purposes. Under the 409A proposed regulations, which were issued in September, 2005, there are *two detailed approaches* that may be used to determine the fair market value of stock for purposes of NQSOs or SARs: facts and circumstances valuations, and safe harbor methods.

The Service issued Notice 2006-4 on December 23, 2005, to provide interim guidance on determining the fair market value of outstanding stock rights. Under Notice 2006-4, for stock rights issued before January 1, 2005 (other than those that were vested as of December 31, 2004 and thus "grandfathered" from the application of 409A), the fair market value may be determined by the employer in accordance with the rules governing incentive stock options under Code section 422. These rules generally provide that the exercise price will be deemed to be at least equal to the fair market value of the underlying stock if the employer has made a *good faith attempt* to set the exercise price at fair market value, using a facts and circumstances analysis.

For stock rights issued on or after January 1, 2005 but before the effective date of final 409A regulations (proposed to be January 1, 2007), the employer may determine the fair market value of its underlying stock for purposes of both NQSOs and SARs using *any reasonable valuation method* that satisfies the requirements of Notice 2005-1 even if it does not satisfy the valuation requirements contained in the proposed regulations, although reliance on the standards set forth in the proposed regulations is also permissible. In addition, Notice 2006-4 indicates that final regulations may provide more detailed standards for determining the fair market value of stock related to stock rights.

The Gulf Opportunity Zone Act of 2005 ("GOZA"). On December 21, 2005, the President signed GOZA into law. The primary purposes of GOZA are to provide (1) tax benefits to businesses and individuals in the Hurricane Katrina disaster area, and (2) financial incentives for reconstruction in that disaster area. But, GOZA also included several technical corrections affecting 409A.



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The technical corrections clarified that the subsequent election rules of 409A apply even if there was not a first election by the employee. For example, an amendment by the employer changing the form of a benefit under a defined benefit SERP would be subject to the second election rules, even though the executive never made a "first election" of the form or timing of the benefit. (This means the limits on the timing of the amendment and the commencement of payments will apply as if the participant made a second election equal to the amendment's terms.) GOZA also clarified that the tax imposed on a 409A violation is not counted as part of the tax paid by the individual when determining if the alternative minimum tax calculation applies. This will impact executives with significant tax preference items, *e.g.*, the preference that arises when an incentive stock option is exercised. This increases the potential tax impact of a violation to an executive.

GOZA also requires the Service to issue guidance, within 90 days of its enactment, regarding funded offshore trusts and trusts triggered by a change in the financial health of the employer, that will permit any nonqualified deferred compensation arrangement that includes such a funded offshore trust or a financial health trigger provision a specified period in which to conform to the guidance. GOZA clarified that the effective date for the funded trust rules was January 1, 2005. Because pre-existing nonqualified deferred compensation arrangements may have had such funded offshore trusts or financial health trigger provisions when 409A became effective, such arrangements would have failed to satisfy 409A's funding prohibitions, in the absence of an adequate opportunity to correct any defect. Thus, GOZA requires the Service to provide a limited period of time to conform such trusts to the new law.

If you have any questions regarding the foregoing, or for assistance in complying with 409A, please feel free to contact one of the attorneys listed below.

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