

EXECUTIVE COMPENSATION

Avoiding Restrictions on Nonqualified Stock Options and Stock Appreciation Rights

The Problem

Options to buy company stock ("stock options") and rights to share in the appreciation of company stock ("stock appreciation rights" or "SARs") are a tax-advantaged way to reward key employees without having to pay out additional current compensation. However, proposed regulations to newly enacted §409A of the Internal Revenue Code impose restrictions on stock options and SARs. Failure to satisfy §409A results in immediate taxation of the value of the stock options or SARs, imposition of imputed interest, and a 20% penalty tax.

How can stock options and SARs avoid the restrictions under Code Section 409A?

The Solution

Stock options that meet the various requirements of Code Section 422 (termed "incentive stock options" or "ISOs") automatically avoid the new deferred compensation restrictions under Code Section 409A. Other stock options (termed "nonqualified stock options" or "NSOs"), as well as SARs, are generally subject to Code Section 409A, with two significant exceptions:

Short-Term Deferrals. NSOs and SARs that must be exercised within 2-1/2 months after the end of the year in which a substantial risk of forfeiture (such as continuing future service) lapses, or within 2-1/2 months after the end of the year in which granted without any substantial risk of forfeiture, are not covered by §409A. For example, if an NSO with five year vesting requires exercise within 2-1/2 months following the end of the vesting period, § 409A does not apply. *Observation:* This short exercise period may not be attractive to key executives if it is seen as too inflexible to enable them to benefit from long-term growth in the company's stock before the options must be exercised.

Non-Deferral of Compensation

NSO – An NSO is treated as not deferring income for §409A purposes where (i) the exercise price for the NSO can never be less than the fair market value of the underlying stock on the date the NSO is granted; (ii) the number of shares subject to the NSO is fixed on the grant date; (iii) the exercise of the NSO is taxable; and (iv) the NSO does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the NSO.

SAR – A SAR is treated as not deferring income for §409A purposes where: (i) compensation payable under the SAR can never be greater than the difference between the fair market value of the stock on the date of grant of the SAR and the fair market value of the stock on the date of exercise; (ii) the SAR exercise price can never be less than the fair market value of the underlying stock on the grant date; and (iii) the SAR does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the SAR.

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