Code Sec. 409A in Acquistions

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Internal Revenue Code Section ("Code Sec.") 409A provides that amounts deferred under a nonqualified deferred compensation plan must be currently included in gross income

if they are not subject to a substantial risk of forfeiture and have not previously been included in gross income. Yet, there is a large "but" to this general rule. If one meets certain requirements, one can fall outside this harsh rule and back into what one might think of as traditional deferred compensation rules.

A nonqualified deferred compensation plan includes virtually any agreement, method, program or other arrangement that provides for deferral of compensation, where the compensation is not paid until a later tax year. The following types of arrangements and agreements are among the many types of arrangements that are covered by the broad reach of Code Sec. 409A:

- Any employment, bonus or compensation agreement (even covering only one employee) that results in the deferral of the taxation of compensation
- Supplemental executive retirement plans (sometimes called "SERPs") and other nonqualified retirement arrangements
- Restricted stock, phantom stock and performance share plans
- Code Sec. 457f plans
- Certain stock appreciation rights
- Many long-term or multi-year bonus or commission programs

Get the Documents

Change in control agreements, severance agreements, employment agreements, agreements covering the delayed payout of option proceeds, *etc.*, can all be brought within the reach of this provision. If you have never considered some of these issues, you are likely to consider them when you ask a potential target company to produce copies of all nonqualified deferred compensation plans and agreements.

For tax as well as nontax reasons, buyers are likely to want to know about everything to do with the business they are buying. Sellers in some respects may want to disclose everything as a means of reducing seller liability. But in others, sellers want to respond only to what's being requested.

Today, target counsel are likely to ask for information and documentation regarding all nonqualified deferred compensation plans within the meaning of Code Sec. 409A.

One must differentiate between public and private companies, since Code Sec. 409A has broader reach with publicly held entities.

For example, there is a six-month delay rule in the case of distributions to certain employees. In general, these include key employees from publicly held corporations. Because of the presence of such rules, one should consider a matrix of queries for public to public company acquisitions, public to private acquisitions, and private to public acquisitions.

Options

In general, the following types of stock options are treated as nonqualified deferred compensation under Code Sec. 409A if the stock options have an exercise price that is less than the fair market value of the underlying stock on the date of the grant:

- Options granted and vested before January 1, 2005, if they were materially modified on or after October 3, 2004
- Options granted before January 1, 2005, but that were not fully vested as of January 1, 2005 (provided that Section 409A will apply only to the unvested portion of the option)
- Options granted on or after January 1, 2005.

Code Sec. 409A rules are triggered depending upon whether the option was granted with an exercise price equal to or greater than fair market value. That may mean it can be relatively easy with stock options to plan around the applicability of Code Sec. 409A. However, the buyer should carefully review the target's option practices to verify pricing. That should include resolutions and specific option grants.

Beware "Material Modifications"

A "material modification" of options can also be significant when it comes to Code Sec. 409A. A material modification generally means the material enhancement of a benefit or right existing as of October 3, 2004, or the addition of a new material benefit or right that affects the amount earned and vested before January 1, 2005.

The acceleration of option vesting and cashing out options on closing can have significant traps. For example, if the options were discounted (granted at less than fair

market value) and the options are accelerated as to vesting or payment of cash to optionees in connection with the termination of the options, Code Sec. 409A may subject the optionee to taxation.

Other Equity Arrangements

In addition to stock options, other equity granting policies should be reviewed. The key issue is the extent to which options or equity are granted based on an exercise price that is equal to or greater than fair market value. However, one can trigger Code Sec. 409A applicability with deferral features on equity issuances.

Employment and Severance Agreements

Severance agreements and employment agreements for the employees of the target should consider Code Sec. 409A implications. Such agreements may be written in an attempt to make a target employee whole. For example, one might offer replacement money or consideration for some kind of deferred compensation benefit that is not going to be available.

This is important, since entitlement or payment of benefits that act as a substitute for (or replacement of) amounts considered to be deferred compensation under a plan can also be viewed as subject to Code Sec. 409A. In appropriate cases, the right to the new payment or new agreement can be considered an impermissible acceleration of payment of the forfeited deferred compensation.

Conclusion

Even in transactions that seem simple and straightforward, the potential impact of Code Sec. 409A on acquisitions is large.

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