Lowenstein Sandler's Employee Benefits & Executive Compensation Podcast: Just Compensation

Episode 42 – Stock Options and Section 409A: What You Need to Know

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Jessica Kriegsfeld: Welcome to the latest episode of Just Compensation. My name is Jessica Kriegsfeld and I'm an associate in Lowenstein Sandler's Executive Compensation Employment and Benefits Practice Group. I'm joined today by two members of my group, Darren, the vice chair, and Taryn, counsel. Section 409A of the tax code is a lengthy and complicated set of rules regulating the taxation of non-qualified deferred compensation, including equity awards. Equity awards must be structured carefully with section 409A in mind to avoid a section 409A violation. If an equity award violates section 409A, the award will be immediately taxable, and the award holder could incur a penalty tax and other potential penalties.

In previous episodes, we discussed how to structure certain other types of equity compensation to avoid the unwanted consequences of a 409A violation. Today's episode will expand on those discussions and focus on stock options specifically. We will discuss the nuances of structuring stock options in a way that works under section 409A and discuss some high-level considerations to be aware of if you're thinking about granting stock options. As always, this is not intended to be an exhaustive discussion, so we encourage you to consult with your legal counsel if you wish to grant stock options. To start, Taryn, do you need to be thinking about section 409A if you want to grant stock options?

Taryn Cannataro: The short answer is yes. If you run into a 409A issue, it changes the tax treatment of the options. At a high level, if a stock option violates section 409A, it starts to become taxable on any gains in the year it vests, even if the option has not been exercised. On top of ordinary income tax, the option holder will incur an additional 20% penalty tax plus potential interest penalties.

Jessica Kriegsfeld: This is a problem for the person receiving the options, not the company issuing them?

Taryn Cannataro: Not exactly. The company that issues the options has an obligation to properly report and withhold taxes if there are 409A violations. If it doesn't do so, it can have exposure. As a practical matter, if a company has employees who are disgruntled because of tax problems, it's usually also a company problem.

Jessica Kriegsfeld: Darren, at a high level, what's required for a stock option to work under section 409A?

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Darren Goodman: Theoretically, there's a number of different ways that options can be structured in a way that works under 409A. But in practice, the overwhelming majority of the time, they are designed to fit into what's called a stock option exemption from 409A. To fit into that exemption, there's a number of requirements, but there's two that come up most frequently. The first one is that the exercise price of the option has to be at least fair market value of the stock on the day that the option is granted. That's the reason that such emphasis is put on making sure that the exercise price is at least fair market value. That the exercise price should be at least fair market value is something that's fairly widely known, but it's much less known that the reason for doing so is to fit into this stock option exemption under 409A. The other requirement that can sometimes cause an issue is that the option must be an option to purchase what the IRS regulations call service recipient stock.

Jessica Kriegsfeld: What does it mean for a stock option to be service recipient stock?

Darren Goodman: That's a very technical term. In plain English, it means first that the option is on common stock. If you see stock options, almost always they will be for common stock. There is a narrow exception where a stock option can be for preferred stock, but that's definitely something that requires advanced planning with tax counsel to make sure that there's not a problem under 409A. In addition, at a high level, the option has to be for stock and the company that the person is working for on the date the option is granted. It's also fine for an option holder to work for a subsidiary of the company granting the option, assuming it's at least a 50% owned subsidiary, or potentially in some circumstances as low as 20%. Usually these requirements aren't a problem, but there can be situations where it does come up.

For example, if a company wants to grant an employee of a parent entity an option of a subsidiary, or if you've got a potential employee who you want to grant options, there's a way to do that, but you have to structure it right under 409A. Or in some instances you have a former employee who was promised an option, and it was never granted before the person terminated, that also would be someone who's not providing services on date of grant. That's definitely something that you would want to discuss with counsel.

Other requirements for service recipient stock, first, let any repurchase rights or put or call rights are for a fair market value purchase price, except for narrow situations like if someone's terminated for cause. For example, suppose the company has stock that's worth $10 and granted options as an exercise price of $10, but the company also says that if the employee exercises, he can sell the stock back to the company for $100 because they want to guarantee some gains. That's an issue under these rules that I'm talking about.

Jessica Kriegsfeld: What if a company wants to grant to someone who hasn't started yet? For example, the board is meeting and wants to approve stock options for new hires who will be starting soon but haven't started yet.

Taryn Cannataro: That's doable under 409A, but you need to be careful because that may or may not be permitted under the plan that the options are granted under. There are also securities laws considerations that come along with that. For example, the typical securities exemption for option grants, rule 701, isn't available in this scenario, so you would need an alternate exemption.

Jessica Kriegsfeld: As we mentioned earlier, in order to be exempt from 409A, the exercise price of the option must be at least fair market value on the date the stock option is granted. That sounds simple enough for a company that's public since that's market price. But how do you determine fair market value for purposes of setting the exercise price for private companies?

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Taryn Cannataro: For private companies, the regulations say that fair market value must be determined by the reasonable application of a reasonable valuation method, which doesn't provide much practical guidance. The regulations do enumerate some factors to be considered, which include the value of tangible and intangible assets of the corporation, the present value of anticipated future cash flows of the corporation, the market value of equity interest and substantially similar entities, the value of which can be determined through nondiscretionary objective means, recent arm's length transactions, control premiums, and discounts for lack of marketability. But again, for a company asking themselves what is the fair market value of our stock, it's often hard to take these factors and calculate a value.

Fortunately, the IRS regulations provide an alternative. If a valuation is obtained from an independent appraiser, the valuation is entitled to a rebuttable presumption of accuracy, rebuttable only by showing that the valuation is grossly reasonable, which is a pretty high bar. These are options referred to as 409A valuations. To benefit from the presumption of accuracy a 409A valuation provides, the valuation can be no more than 12 months old, and that's 12 months from the date the stock is valued, not the date of the report. If a company got a report today that valued their stock as of 1/1/2024, the presumption would only last through 2024. Even if the valuation is less than 12 months old, it can become unreliable if a material event occurs. There's no bright line as to what is or is not a material event, and this is something that requires discussion with counsel if you want to grant options and think your 409A valuation may no longer be reliable.

Jessica Kriegsfeld: Got it. Suppose that I own a company and grant options, and make sure that my exercise price is at least fair market value and the other 409A requirements are complied with. Am I all set, or is there anything else I need to think about?

Darren Goodman: If no changes are being made to the option, you're pretty much set but not entirely. The reality is, though, that unexpected things can happen, and a company may want to make changes. Things like accelerating vesting or allowing the exercise price to be paid via a net exercise, those aren't 409A issues. But if the options are incentive stock options, then you'd want to think about any consequences there. That's a topic for another podcast. If you lower the exercise price of stock options, commonly called a repricing, that's something that needs to be considered under 409A. In short, it can be done under 409A and in fact happens pretty regularly, but there are nuances that would need to be considered. It's really a case-by-case analysis if a company wants to reprice their stock options, and we have an entire podcast episode on that.

Another issue that's not uncommon is that the option approaches the original expiration date and has not been exercised yet, and it's difficult for people to exercise because in addition to the exercise price, there's often a lot of gains that would yield taxable income on exercise. It's not that common for options to reach their expiration date without being exercised, because usually options have a 10-year window, and that's a long time. But it does happen from time to time. Simply extending the expiration date for an option that's in the money, meaning the fair market value is greater than the exercise price, simply extending that is going to normally be a problem under 409A. There's no silver bullet to fix that. There's a range of potential options, but no perfect fix. Again, it's a case-by-case approach. Just to be clear, these are two common types of issues that come up, but they're not an exclusive list, so definitely keep counsel in the loop on any stock option matters.

Jessica Kriegsfeld: Suppose I'm listening to this podcast, and I'm concerned that I may have a 409A issue. What should I do?

Taryn Cannataro: That's something to talk to legal counsel about. There could be fixes, but it's definitely a situation where individual circumstances can vary. In general, though, we would

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say that if you think you have a 409A issue, it's better to address it sooner rather than later. A 409A violation is usually not the type of thing that gets better by itself with time.

Jessica Kriegsfeld: As today's discussion explained, if structured correctly, stock options can be fine under section 409A. Ensuring that your options are structured correctly can require complex analysis and coordination with legal counsel. If not structured properly, the option holder can incur costly penalty taxes, and it can both create liability for the company and present an employee relations issue. We hope that today's discussion provided you with an overview of some key considerations to keep in mind when granting stock options. This episode is intended to be a high-level overview but is by no means an exhaustive discussion. Thanks for joining us today. We look forward to having you back for our next of Just Compensation.

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