



BDO Seidman, LLP  
Accountants and Consultants

# Washington Tax Report

## Issues Covered:

IRC Section 409A Final Regulations Released .....	1
Stock Options and SARS .....	1
Valuation .....	2
Severance Pay .....	2

## Contributing Authors:

### Jessica Schuster

312-856-9100  
jschuster@bdo.com

### Derrick Neuhauser

312-856-9100  
dneuhauser@bdo.com

*Material discussed is meant to provide general information and should not be acted on without obtaining professional advice appropriately tailored to your individual needs.*

*To ensure compliance with Treasury Department regulations, we wish to inform you that any tax advice that may be contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or applicable state or local tax law provisions or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.*

Visit our website: [www.bdo.com](http://www.bdo.com)

## IRC Section 409A Final Regulations Released

After much anticipation by practitioners and companies, the Department of Treasury and Internal Revenue Service issued final regulations under Internal Revenue Code Section 409A on April 10, 2007. IRC Section 409A regulates the taxation of a wide spectrum of nonqualified deferred compensation plans and many compensation arrangements. The regulations adopt most of the earlier guidance originally issued in 2005 and in subsequent notices. (Please see previous Washington Tax Letters for discussions with respect to the original adoption of IRC Section 409A and prior Treasury guidance.) The final regulations require that nonqualified deferred compensation plans be in documentary compliance by January 1, 2008, but companies must be in operational “good faith” compliance until then. There are a number of key changes in the final regulations relating to the modification of stock options and stock appreciation rights, the valuation of private company stock and severance pay following an involuntary separation from service.

## Stock Options and SARS

The proposed regulations provided that any extension made to a stock right on termination of employment beyond the end of the taxable year would be considered to add an additional deferral feature or a modification and therefore would be subject to IRC Section 409A and a possible 20% excise tax. However, the final regulations provide that an extension can be made beyond that time but no later than the earlier of the end of original term of the stock right or ten years from the grant date. This reprieve allows companies more flexibility on terminations of key employees.

The final regulations also provide that if a stock right is “underwater” at the time of the extension, it will be considered a new award of stock and such award does not fall under the scope of IRC Section 409A. Lastly, the final regulations provide that extensions made before April 10, 2007 will not be considered to have an additional deferral and will not be subject to IRC Section 409A and the applicable penalties and interest.

### Valuation

One of the stipulations for a stock right to be exempt from IRC Section 409A is that the stock right cannot be issued at a discount or provide for any additional deferral feature. This can create a burden for private companies regarding the determination of fair market value. The final regulations require that the fair market value must be determined by the reasonable application of a reasonable valuation method. The determination of whether the valuation method was reasonable is a facts and circumstances test. Consistent with the proposed regulations, three safe harbor methods are provided. These include an independent appraisal, a reasonable method of formula based valuation, and for illiquid stock of businesses less than 10 years old with no expected change in control within 90 days or IPO within 180 days, a good faith value from a qualified issuer. Such qualified issuer does not have to be independent. Guidance as to who may be qualified to perform the valuation is also provided in the final rules.

### Severance Pay

The proposed regulations provided for some exemptions from IRC Section 409A

with respect to severance pay. Under the proposed regulations, severance pay for involuntary separation from service is exempt if two criteria were met; the amount was paid no later than the end of the second year following the year of termination and the amount paid did not exceed the lesser of (1) two times the preceding year annualized compensation or (2) two times the qualified plan compensation limit for the applicable year (\$225,000 for 2007). The proposed rules indicated that if the severance amount exceeded the lesser of these limits, the entire amount was subject to IRC Section 409A. The final rules clarify that only the excess over the limitation is subject to the rules, which in turn provides that only this excess amount paid to “key employees” for publicly traded companies must be delayed six months before being paid out.

Under the proposed regulations severance pay for voluntary terminations for “good reason” would be subject to IRC Section 409A. The final regulations expanded this concept by providing that in some circumstances, such payments made for voluntary “good reason” terminations may be treated in the same way as payments made subsequent to an involuntary termination. In order to be eligible for this treatment, payments made for “good reason” must not be structured in order to avoid IRC Section 409A and must be paid subsequent to a termination due to a negative change in employment for the employee. It is also necessary that these payments be similar to those provided for involuntary separation from service in order to qualify for this treatment.

The final regulations also provide a safe harbor which allows payments that are made due to separation from service for “good reason” to be treated as pay-

ments made due to an involuntary termination. This safe harbor is available only if all of the three following conditions are met: 1) the amount must be payable within a predetermined period of time following the termination; 2) the payment must be structured in the same manner as that following an involuntary termination; 3) the employee must notify the company of the termination for good reason within 90 days of the event leading to the termination, and the company must be allowed 30 days following such notification to fix the condition causing the termination for good reason.

There were some issues which were expected to be addressed under the final regulations, but were not. The Treasury Department has indicated that subsequent guidance will be forthcoming. For example, the final regulations did not address the calculation and timing of amounts required to be included in income, nor the withholding and reporting requirements of such amounts. Another key issue which was not addressed is the application of IRC Section 409A to offshore trusts for which it was provided that until further guidance is issued, taxpayers must continue to rely on Notice 2005-1 and remain in “good faith” compliance.

Nonqualified deferred compensation plans that do not comply with the IRC Section 409A may subject the participants to immediate taxation upon vesting, an additional 20% excise tax plus interest and penalties, which makes compliance by December 31, 2007 crucial.

Should you have any questions regarding Section 409A, please do not hesitate to contact the contributors.