

Part III – Administrative, Procedural, and Miscellaneous

Interim Guidance with Respect to the Application of Section 409A to Outstanding Stock Rights

Notice 2006-4

I. Background

Section 409A was added to the Internal Revenue Code as part of the American Jobs Creation Act of 2004, Pub. Law No. 108-357, 118 Stat. 1418. Section 409A generally provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are met. The IRS issued Notice 2005-1, 2005-2 I.R.B. 274, on December 20, 2004 (published as modified on January 6, 2005) and issued proposed regulations under section 409A on September 29, 2004 (70 Fed. Reg. 57930 (Oct. 4, 2005)). The proposed regulations are proposed to be effective on January 1, 2007, and do not limit the application of the guidance provided in Notice 2005-1.

II. Stock Options and Stock Appreciation Rights Granted before January 1, 2005

A. Application of the Reasonable Valuation Standard

Commentators expressed concern with respect to the application of section 409A to stock options and stock appreciation rights (collectively, stock rights) issued before January 1, 2005. Specifically, commentators expressed concern that although the issuers of the stock rights intended to establish an exercise price not less than the fair market value of the stock at the time of grant, the issuers of the stock right may not be able to demonstrate that the exercise price of the stock right was determined using a reasonable valuation method in accordance with the requirements set forth in Notice 2005-1, Q&A-4(d) or § 1.409A-1(b)(5)(i)(B) of the proposed regulations. Commentators noted further that at the time such stock rights were granted, section 409A had not been enacted and thus no guidance with respect to the application of section 409A to stock rights was available.

B. Application of the Good Faith Standards of § 1.422-2(e)(2)

Section 1.422-2(e)(1) generally provides that except as provided by § 1.422-2(e)(2), the option price of an incentive stock option must not be less than the fair market value of the stock subject to the option at the time the option is granted. Section 1.422-2(e)(2) generally provides that if a share of stock is transferred to an individual pursuant to the exercise of an option which fails to qualify as an incentive stock option merely because there was a failure of an attempt, made in good faith, to meet the option price requirements of § 1.422-2(e)(1), those option price requirements are considered to have been met. Whether there was a good-faith attempt to set the option price at not less than the fair market value of the stock subject to the option at the time the option was granted depends on the relevant facts and circumstances.

Until further guidance is issued, with respect to a stock right issued before January 1, 2005, for purposes of determining whether the stock option results in a deferral of compensation pursuant to Notice 2005-1, Q&A-4(d)(ii), or the stock appreciation right results in a deferral of compensation pursuant to § 1.409A-1(b)(5)(i)(B) of the proposed regulations, principles similar to those set forth in § 1.422-2(e)(2) will be applied. Accordingly, where there was a good-faith attempt to set the exercise price of a stock right granted before January 1, 2005, at a price not less than the fair market value of the stock subject to the stock right at the time the stock right was granted, then such exercise price will be treated as being not less than the fair market value of the stock at the time of grant for purposes of determining whether the stock right is excluded from the requirements applicable to deferred compensation under section 409A.

III. Stock Rights Issued on or after January 1, 2005 and Continued Application of Notice 2005-1, Q&A-4(d)(ii)

With respect to stock options granted on or after January 1, 2005 and before the effective date of final regulations, Notice 2005-1, Q&A-4(d)(ii) remains applicable guidance. Taxpayers may also rely on § 1.409A-1(b)(5)(i)(B) of the proposed regulations during this period. With respect to stock appreciation rights issued on or after January 1, 2005 and before the effective date of final regulations, taxpayers may rely on § 1.409A-1(b)(5)(i)(B) of the proposed regulations. In applying the provisions of the proposed regulations relating to stock appreciation rights, and specifically § 1.409A-1(b)(5)(i)(B)(1) and (2), taxpayers may apply the rule set forth in Notice 2005-1, Q&A-4(d)(ii) that, for purposes of determining the fair market value of the stock at the date of grant, any reasonable valuation method may be used. Accordingly, where a taxpayer can demonstrate that the exercise price of a stock right, granted on or after January 1, 2005, and before the effective date of final regulations, is intended to be not less than the fair market value of the stock at the date of grant and that the value of such stock was determined using a reasonable valuation method, then that valuation will

meet the requirements of Notice 2005-1, Q&A-4(d)(ii) regardless of whether that determination satisfies the valuation requirements in § 1.409A-1(b)(5)(i)(B) of the proposed regulations.

IV. Request for Additional Comments regarding Application of Final Regulations to Outstanding Stock Rights

Final regulations may establish more detailed standards for valuation in the context of stock rights than those provided in this Notice and Notice 2005-1. The Treasury Department and the IRS continue to request comments with respect to the proposed regulations, and specifically how the standards proposed with respect to the determination of the fair market value of stock subject to stock rights may be improved both to meet commentators' requests for more certainty with respect to the valuation requirement, and the legislative intent that only stock rights with exercise prices that may not be lower than the fair market value of the underlying stock on the date of grant be excluded from coverage under section 409A. See H.R. Conf. Rep. No. 108-755, at 735 (2004).

In addition, commentators have expressed concerns relating to the definition of service recipient stock for purposes of the exclusions from coverage under section 409A for certain stock rights, and the treatment of modifications, extensions and renewals of otherwise excluded stock rights. The Treasury Department and the IRS are considering comments on these issues, and invite further comments with respect to the rules proposed under the proposed regulations, as well as any additional transitional relief that may be appropriate in conjunction with the implementation of the final regulations. For information regarding the submission of comments, see the "Comments and Public Hearing" section of the preamble to the proposed regulations.

V. Drafting Information

The principal author of this guidance is Stephen Tackney of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the Treasury Department and the IRS participated in its development. For further information regarding this notice, contact Stephen Tackney at (202) 927-9639 (not a toll-free call).