

High Tech Counsel Corner

We do not stray very often into the world of federal taxes in this column, as brevity does not lend itself well to the complexities of federal tax law. And, while we do not want to depart from that sound practice here, we do believe it is important to point out the potential impact of the 2004 American Jobs Creation Act (AJCA) on high technology companies and the need to act soon to address the issues.

The AJCA added Section 409A to the Internal Revenue Code. Section 409A makes significant changes to federal tax law affecting non-qualified deferred compensation arrangements. Deferred compensation can take many forms, including stock options and stock appreciation rights. Many companies have stock option plans which permit the granting of both incentive stock options (ISOs) and non-qualified stock option (NQOs). A stock option must pass several tests in order to be treated as an ISO, including a requirement that its exercise price not be less than the fair market value of the underlying stock at the time of the grant of the option. By contrast, NQOs have been viewed as being more flexible from a tax perspective, including the ability to use an exercise price that is less than the stock's fair market value at the time of grant.

Section 409A has now changed the analysis – in particular, in the case of an NQO with an exercise price which was less than the stock's fair market value at the time of grant. (Section 409A does not distinguish between ISOs and NQOs, and ISOs must also meet the fair market value test under Section 409A.) Depending upon when the NQO was granted, when it vests, and when it may be exercised, a "below-market" NQO may subject the employee/option holder to significant adverse tax consequences: compensation income at the time of vesting (not exercise), interest for underpayment of taxes, and a 20% penalty. Other elements of an NQO may also give rise to application of Section 409A, and thus the provisions of each NQO must be reviewed in detail.

Until December 31, 2006, existing deferred compensation arrangements, including NQOs, may be amended to meet the requirements of Section 409A. What amendments are permitted and appropriate depends upon the terms of the arrangement and the goals sought to be achieved.

There are various strategies to conform NQOs and other deferred compensation arrangements to the requirements of Section 409A. We encourage you to seek advice from a knowledgeable tax advisor as to the application, requirements, and consequences of Section 409A to your company's stock option and other deferred compensation programs.



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