New York State Bar Association

Tax Section

Employee Benefits Committee

Report on Section 409A

of the Internal Revenue Code and

Internal Revenue Service Notice 2005-1

June 28, 2005

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Background

Section 409A of the Internal Revenue Code of 1986 (the "Code")[1] was added by the American Jobs Creation Act of 2004 (the "Jobs Act") and for the first time provided a detailed statutory basis for the federal income taxation of nonqualified deferred compensation. In adding Section 409A, Congress broke the regulatory logjam created when, in Section 132 of the Revenue Act of 1978, it effectively stopped the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") from regulating nonqualified deferred compensation. In enacting Section 409A, however, Congress entered a highly complex and technical area with a relatively brief new statutory provision and did so in a way that has indirect ripple effects throughout the field of compensation taxation.

In a responsive and thoughtful effort, Treasury and the Service issued prompt but preliminary guidance and needed transition relief in Notice 2005-1. There are many difficulties that could have arisen with the fundamental application of the statute had Treasury and the Service not taken the careful and thoughtful approach that they took in Notice 2005-1, particularly Q&A 4(c).[2] The conceptual underpinnings laid down, for example, in Q&As 3, 4, 5, 9 and 10, and especially Q&A 4(a) and (c), appropriately exclude many items from the unintended reach of the statute. Many of our comments are intended to refine this approach without opening the door to abusive practices.

We set forth some comments to positions initially taken in Notice 2005-1 and, more generally, in respect of Section 409A.[3] Historically, particularly in light of Section 132 of the Revenue Act of 1978, general principles of constructive receipt have governed the taxation, and, notably, the timing of the taxation, of deferred compensation. In many respects, Section 409A was enacted to halt perceived abuses by which executives and other service providers could in practice manipulate the applicable timing rules and achieve a level of flexibility that was seen as improper.

In this regard, according to the report issued by the House Ways and Means Committee,[4] Section 409A was meant to address nonqualified deferred compensation arrangements that are considered by Congress to allow improper deferral of income, such as an arrangement that purports to defer compensation for tax purposes but effectively provides the participant security of future payment and control over amounts deferred. Examples of such arrangements cited in the House Report are "haircut" provisions, which allow participants to receive distributions upon request subject to forfeiture of a minimal amount, and offshore "rabbi trusts," the assets of which are, under the terms of the trust, subject

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1 All section references herein are to the Code, unless otherwise specified.

2 References to Q&As are to the numbered questions and answers in Notice 2005-1, unless otherwise specified.

3 The principal authors of this report are Andrew L. Oringer and Max J. Schwartz. Significant contributions were made by Frank A. Daniele, Elie Fink, Edmond T. FitzGerald, Andrew L. Gaines, Mark T. Hamilton, George R. Ince, Jr., Jonathan F. Lewis, Michael J. Nassau, Martin Nissenbaum and Kenneth A. Raskin. Helpful comments were provided by Kimberly S. Blanchard, David P. Hariton, Stephen B. Land, David S. Miller and Michael L. Schler.

4 H.R. Rep. No. 548, 108th Cong., 2d Sess. ("Conf. Rep.").

to creditors' claims in the event of the employer's bankruptcy, but are difficult or impossible for creditors actually to reach. To address these types of arrangements, Section 409A is meant to provide specific rules governing the deferral of income.

Against this backdrop, we have approached the preparation of our comments from the perspective that the statute should be interpreted to effectuate the goal of limiting or eliminating abusive practices regarding the manipulation of the timing of income inclusion while not overly restricting legitimate compensatory practices.

Thus, traditional and reasonable compensation tools should not be proscribed merely because the statutory language casts a potentially wide net, nor should penalties be imposed on employees who may be covered by such practices and have no real control over their design or implementation. We respectfully submit that Congress could not possibly have anticipated the details or the level of complexity and ramifications resulting from the general rules in the statute, which is why it recognized the need for regulatory precision by expressly delegating to Treasury (in Section 409A(e)) the responsibility to provide interpretation and exceptions.

We think every effort should be made not to cause an arrangement to be subject to the punitive regime of Section 409A, even if it might share some structural or other tangential relationship to those items that are the legitimate objects of the statute; and, once those legitimate objects have been identified, the rules should be narrowly drawn so as to address abusive situations, while allowing taxpayers to structure their affairs as they deem appropriate from a compensation perspective, in nonabusive situations. In light of these general principles, we have endeavored to make suggestions that (i) have a basis in some existing precedent, (ii) interfere as little as possible with legitimate compensatory practices that have independent business attributes apart from the deferral of taxation, (iii) do not impose greater formality on regular compensatory practices than is required to monitor compliance with the statutory framework and regulatory exceptions, (iv) keep solutions to those that are susceptible of being implemented and enforced in a uniform and practical way, and (v) yet provide reasonable assurance that the abusive practices at which Section 409A is aimed will be curtailed. It is against that backdrop that we provide the following comments.

Executive Summary

Several of our recommendations can be briefly summarized as follows:

1. Definition of "Plan" for Penalty Purposes

For purposes of the application of the penalties for failure to comply with Section 409A in form or practice, the aggregation of arrangements that constitute a single plan should be refined beyond the three categories specified in Notice 2005-1. We recommend that, within each of the account balance and non-account balance categories, plans be distinguished by other factors, such as whether or not participation is elective, whether the election applies to salary or to other compensation, and whether the arrangement is linked to and directly supplements a tax-qualified retirement plan. We suggest other distinctive characteristics be considered as more fully discussed in the body of our report.

2. Definition of "Deferred Compensation"

(a) Treasury and the Service should consider qualifying the definition of "deferral of compensation" with a list of certain express exceptions that may be expanded in the future through the issuance of Revenue Procedures or by other means. Our proposal is intended to ensure that the provisions of Q&A 4(a) and (c) will not have unintended and adverse consequences with respect to employees participating in plans or arrangements for legitimate, independent business reasons of the employer, and are not designed with the intent to defer taxation of compensation, but which may have the incidental effect of resulting in a deferral of compensation (as presently defined in Q&A 4(a)).

(b) Treasury and the Service should also consider a change to the short-term deferral rule of Q&A 4(c) that would allow it to be relied upon by participants who do not in fact elect to defer beyond the year of vesting (or 2-1/2 months thereafter).

3. Special Issues Relating to Equity-Based Compensation

(a) The exclusion for stock appreciation rights ("SARs") should be expanded to include cash settled SARs and should be available whether or not the company's stock is publicly traded.

(b) The "service recipient" condition for the exclusion of nonstatutory stock options and SARs from Section 409A should be relaxed so as to extend to any reasonable service relationship in the case of operating and certain other entities, and so that a 30% level of affiliation would also be considered sufficient to establish an alternative appropriate nexus.

(c) The rules developed relating to post-grant modifications of options and SARs should permit a modification that merely tolls the exercise period of the option or SAR for the time that the holder is prohibited by any law, regulation or rule from exercising the option or SAR if (i) the option or SAR would have otherwise expired during such black-out and (ii) the extension of the exercise period is not beyond 2-1/2 months after the end of the year in which the black-out began. We note that there may be other circumstances the Treasury and the Service may want to consider under which an extension of the exercise period may be permitted (assuming that the extension is not provided in consideration of the service recipient's forbearance of other compensation unrelated to the option or SAR).

(d) The grant of a dividend equivalent right that is paid at the time cash dividends are paid to stockholders of the company should not violate Section 409A.

(e) Where a service recipient grants stock-based compensation that is subject to Section 409A (e.g., certain restricted stock units) that have a post-grant vesting period of at least one year, the participant should be allowed to make any initial elections that may be permissible under such grant within 30 days of the date of grant.

4. Special Considerations Relating to Mergers and Acquisitions, Corporate Restructurings and Reorganizations

(a) Options and SARs adjusted in connection with corporate transactions will not be subject to Section 409A if the adjustment complies with the spread test and the ratio test of Section 1.424-1 of the Treasury Regulations, there is no extension of the maximum term of the options and SARs and the options and SARs held by key employees are treated in the same manner as options and SARs held by others.

(b) Acquirors should have added flexibility to terminate arrangements and pay accrued deferrals should be provided in connection with corporate transactions, whether or not the entity involved is a corporation.

(c) As to cash/share elections, cash payments and delayed payments, first, Section 409A should not apply in a corporate transaction in which (i) equity awards are not deferred compensation, (ii) all holders of those equity awards are given the same election as the other shareholders to receive cash, equity or a combination and (iii) the elections given to the holders of those equity awards are substantially the same as the elections given to the shareholders generally. Second, Section 409A should not apply if both the pre-transaction and post-transaction arrangements are not deferred compensation, even if the conditions in the foregoing clauses (ii) and (iii) are not met. Third, if the equity awards are deferred compensation, but the conditions of such clauses (ii) and (iii) are met, a cash payment pursuant to such an election should be allowed as a permissible acceleration. Fourth, the cancellation for cash of stock options or SARs that do not constitute deferred compensation in a corporate transaction should not be an event to which Section 409A applies. Fifth, certain indemnification and earn-out arrangements should be considered to result in a substantial risk of forfeiture, such that payment of amounts pursuant to these arrangements shortly after the dates specified in the transaction agreement would be short-term deferrals within the meaning of Q&A 4(c).

5. **Payments Relating to Employment Termination (Severance)**

(a) Severance should be recognized as a special form of payment that is not conducive to the regulatory framework contemplated by Section 409A regarding time and form of elections.

(b) Severance should be defined as payments or benefits offered to a service provider which (i) are not in the nature of previously deferred compensation or retirement benefits, and (ii) are provided in connection with a termination of the provider's services; but only if and to the extent payments were not required to be provided to the service recipient on any termination or on any termination without cause (i.e., a payment will not be treated as severance to the extent the service recipient was generally required to make the payment upon termination, even if no payment is required upon termination for cause).

(c) For any service provider who is not a key employee at the time of termination, severance should not be treated as subject to any part of Section 409A.

(d) For any service provider who is a key employee, severance should not be subject to Section 409A, except Section 409A(a)(2)(B)(i) (the six-month payment delay), subject to the exception set forth in paragraph (f) below.

(e) However, if the severance benefit is provided pursuant to an arrangement adopted, entered into or materially modified as to the amount, timing or conditions of payment within the 12-month period immediately prior to the date of termination of service (i) its payment will be subject to Section 409A(a)(2)(B)(i) (with the exception provided in paragraph (f) below) and (ii) it will be subject to all of the provisions of Section 409A unless it can be established by clear and convincing evidence that the severance benefit is not provided in forbearance of any other obligation of the service provider to the service recipient which was in the nature of deferred compensation.

(f) Even if a person is a key employee receiving severance benefits otherwise subject to Section 409A, any cash severance payments made within the six-month period after termination of service will not violate Section 409A if the aggregate of such payments made during such six-month period generally does not exceed 50% of the key employee's historical average annual salary and bonus reported on his W-2 for the preceding five taxable years (or lesser period of employment), adjusted to exclude certain extraordinary items. (A key employee would include any employee who is an executive officer at the time of payment.)

6. Application to Hedge Funds and Other Investment Funds

We propose some special clarifying rules to resolve specific issues in the context of ordinary compensation arrangements involving investment managers. Arrangements addressed include back-to-back procedures, early payment of certain fees and programs sponsored by certain offshore entities.

Detailed Report

I. Definition of "Plan" for Purposes of Section 409A.

Proposal

For purposes of the application of the penalties for failure to comply with Section 409A in form or practice, the aggregation of arrangements that constitute a single plan should be refined beyond the three categories specified in Notice 2005-1. We recommend that, within each of the account balance and non-account balance categories, plans be distinguished by other factors, such as whether or not participation is elective, whether the election applies to salary or to other compensation, and whether the arrangement is linked to and directly supplements a tax-qualified retirement plan. We make specific recommendations as to other distinctive characteristics that should be considered, as more fully discussed below.

Discussion

Q&A 9 groups "plans" into three separate categories (account balance, non-account balance and other); severance can fall into one of the first two categories. Non-compliance for one type of plan would taint all plans in the same category and result in significant taxation with associated penalties for all vested accounts under those plans. These categories were derived from the regulations relating to the timing of taxation for FICA purposes under Section 3121(v) which have a wholly different purpose, i.e., to trigger taxation as soon as it is feasible to do so when amount is deemed "vested."

The definition of "plan" for purposes of Section 409A(a)(1) should protect the integrity of the penalty structure[5] but not extend the penalties beyond what is necessary for the purpose, which is, to us, to deter intentional violations by providing a meaningful downside (rather than just a loss of the benefits of deferral) and to force employers to pay serious attention to the new requirements. The sanctions are harsh on their face and have a considerable potential for unfair results even if the term "plan" is taken simply in its customary meaning, since the penalties are triggered by inadvertent as well as intentional violations.[6] In aggregating arrangements that differ in one or more material characteristics into a single plan, we think that Q&A 9 goes beyond the statutory language and related policy concerns, and should be refined in the forthcoming definitive regulations.

Undoubtedly, the term "plan" in the phrase in Section 409A(a)(i) "under the plan" should be construed to preclude the fragmenting of arrangements that are uniform in their essential characteristics (that is, that are a single plan in substance) into multiple plans in order to limit the scope of penalties. For

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[5] Section 409A(a)(1) imposes a 20% penalty, plus current income inclusion, plus retroactive interest at an enhanced rate on the resulting income tax liability, both on any noncompliant deferrals and on all other deferrals "under the plan."

[6] The likelihood that penalties designed to deter intentional violations will fall heavily on unintentional compliance failures should not be underestimated. Human error is a fact of life, and violations will occur because employees (or outside service providers) do not understand or otherwise fail to carry out instructions intended to ensure compliance, or simply err in interpreting a statute of unanticipated complexity.

example, an attempt to establish a purportedly "separate plan" for each year's deferrals under an arrangement that does not materially differ from year to year should properly be disregarded, based on the traditional principle that substance rather than form should be determinative (and that subterfuges to frustrate statutory intent will not be tolerated).

On the other hand, we do not think that the penalties should be more severe than required by the plain English meaning of the word "plan." To do so would, in our view, go beyond the situation in which Congress applied penalties for Section 409A violations not only to the noncompliant deferrals but also to deferrals that were fully compliant. *At a minimum, arrangements that (i) by their nature and in ordinary understanding are distinct in character, (ii) are so regarded by Section 409A itself through the special provisions designed to regulate such distinct characteristics, and (iii) are accordingly documented as separate plans, should not be aggregated by regulations into a single plan*.[7]

While borderline cases will always exist on whether differences in deferral arrangements have substance so as to warrant separate plan treatment, we believe that the presence of distinct features having material independent significance in operation is a standard that can reasonably be administered and should be adopted in preference to the aggregation rule of the temporary guidance. For this purpose, moreover, we believe that the existence of features specially regulated by Section 409A or separately treated by the regulations sufficiently evidences the existence of materially distinct arrangements to warrant honoring at least a formal designation of the arrangements as separate plans.

If the approach suggested is adopted, plan sponsors may be expected to develop their documentation accordingly and to document their variety of deferred compensation arrangements as separate plans, in order to make clear that violations affecting one arrangement will not warrant imposition of penalties on different arrangements that have been fully compliant. However, we also believe it would be reasonable, on the basis that substance rather than form of documentation should control, to treat arrangements as separate plans where they possess such distinct characteristics, whether or not the documentation expressly refers to them as separate plans.

In determining the extent to which different arrangements should be treated as separate for penalty purposes, the presence or absence of features that are separately regulated seems highly relevant. For example, elective deferral plans are subject to specific rules as to the timing of the deferral that are inapplicable to nonelective plans. It is consistent with the broad language of Section 409A and congressional intent for a failure to observe the election timing rules in an elective plan to subject all deferrals elected by the participants in the plan to the penalties, even if the other deferrals were fully compliant. However, if the same participant benefits from nonelective deferrals under a separate program which has been operated in full compliance with section 409A, it is difficult to see why those deferrals, to which the timing requirements for elective deferrals cannot by their nature apply, should suddenly become subject to penalties because of a compliance failure in the timing of elections.

At a minimum, we submit that nonelective plans should not be aggregated with elective plans so as to become subject to penalties for failures to comply with election timing rules that by their nature do not apply to the nonelective plan.

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7 While Treasury is given wide latitude to prescribe appropriate regulations, and regulations that aggregate different tranches of a single type of program are clearly appropriate, provisions that lump together totally disparate arrangements are likely to be challenged as contrary to the statute, and the courts ruling on such challenge may be expected to consider the severity of the penalties involved in determining whether the regulation has too broad a reach.

While the distinction between elective and nonelective plans seems clear, the question of whether elective plans based on different forms of compensation should be treated as separate is more difficult. The Section 409A timing rules for salary deferrals do not require change from traditional practice prior to the enactment of Section 409A. However, deferrals of bonuses and incentive compensation involve more complex rules, with different rules for bonuses that are performance-based and those that are not. Traditionally, plans that allowed deferrals of both salary and bonuses were documented and operated as single plans, with the only differences being the type of compensation deferred and the timing of the deferral election. Under Section 409A, however, the combination of both in a single plan creates the risk that an error in judgment as to the classification of a bonus would impose severe penalties not only on the bonus deferrals for all years, but also on salary deferrals for which election timing requirements are straightforward and have always been fully observed. Accordingly, arrangements for salary deferrals which do not involve the possibility of such an election timing error, and arrangements for bonus deferrals which involve that possibility, should be considered as separate plans (and possibly treated as separate even if not formally so structured) in order to avoid imposition of a penalty on salary deferrals for a violation of a rule not even applicable to such deferrals.

Applying the principle that deferral arrangements having material features of recognized independent significance should result in separate "plans," separate plans would exist in the following situations:

- *Elective deferral plans would be viewed as separate from nonelective plans*. For this purpose, we believe that matching credits contingent on elective contributions should be regarded as made under the same plan.

- *Elective salary deferrals would represent separate plans from elective bonus deferrals*, for reasons discussed above. Deferrals not implicated in the special bonus rules should not become subject to penalties because of compliance failures involving rules applicable only to bonuses.

- *Defined benefit plans requiring elective deferrals should be treated as separate from elective account balance plans* (as would occur under Q&A 9).

- *Nonelective account balance deferrals and nonelective defined benefit (nonaccount balance) deferrals similarly would constitute separate plans*.

- *Nonelective plans having independent benefit structures*, such as defined benefit arrangements commonly known as supplemental executive retirement plans (or SERPs), *should be separate from excess benefit arrangements tied to an underlying qualified plan* (i.e., providing benefits that such plan would provide but for the Section 401(a)(17) limits on includable compensation and the Section 415 limits, or the Section 402(g) limits if the underlying plan is a "401(k)" plan. In basing their benefits solely on the underlying qualified plan without regard to Code limits on qualified plans, excess benefit plans define their benefits in a materially distinct way from other arrangements using different benefit formulas. Excess benefit plans contain a special potential for Section 409A violations because they are based on underlying qualified plans subject to different rules governing the time and form of elections. We think that an error in operating an excess plan tied to an underlying qualified plan (which could arise from changes in the qualified plan rules incorporated by reference) should not subject to penalties fully compliant deferrals in plans not so linked to the qualified plan.

- *Severance arrangements*, meaning plans that pay benefits only on termination without cause, whether pursuant to a severance plan labeled as such or pursuant to an employment agreement, *should be a separate category* clearly distinct from conventional deferral plans that pay on termination in all events (subject only to plan vesting requirements where applicable).[8] The distinction is also consistent with what we have proposed as a substantial policy consideration: the rules applicable to severance arrangements may be expected to reflect their special characteristics and differ in one or more particulars from those applicable to conventional deferral plans. Thus, we think that fully compliant deferrals under those conventional plans over an employee's period of employment should not be subjected to penalties because of a mishandling of wholly different severance arrangements.

- *The variety of post-employment perks* that may be provided in employment agreements for top management personnel *should represent a further distinct category*. It does not appear that much attention has yet been given to the treatment of items such as car or plan allowances, financial counseling services, club dues and other taxable post-retirement perks that may now be considered to be deferred compensation under Section 409A. In any event, we think that the manner of applying rules designed for conventional plans, such as requiring that the time and form of payment be fixed at the date of deferral, does not readily fit the universe of perks. Accordingly, we believe that such taxable perks should not be aggregated with traditional deferral arrangements. At a minimum, such perks collectively should be viewed as a separate plan. However, we do not wish to rule out the possibility that differences in the treatment ultimately to be accorded various perks under the regulations will warrant the division of perks into subcategories, each of which would be regarded as a separate plan for penalty purposes.

- Consistent with the initial guidance, *equity compensation arrangements, such as stock options and stock appreciation rights, should be viewed as separate from all other arrangements*. In this regard, we presume that, if some stock options or stock appreciation rights qualify for the exception provided in Q&A 4(d) and others fail, and of the failing options only some also fail to comply with the requirements of Section 409A, only the options or rights that fail to qualify for the exception of Q&A 4(d) would be tainted.

II. <u>Deferred Compensation - In General.</u>

<u>Proposal</u>

We propose that:

- Treasury and the Service should consider qualifying the definition of "deferral of compensation" with a list of certain express exceptions that may be expanded in the future through the issuance of Revenue Procedures or by other means. Our proposal is intended to ensure that the provisions of Q&A 4(a) and (c) will not have unintended and adverse consequences with respect to employees participating in plans or arrangements that are not designed with the intent to defer taxation of compensation, but which may in operation cause a deferral of compensation (as presently defined in Q&A 4(a)) for legitimate, independent business reasons of the employer.

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8 The distinct character of severance arrangements is underscored by the specific request for input on severance arrangements made in the preamble to Notice 2005-1.

- Treasury and the Service should also consider a change to the short-term deferral rule of Q&A 4(c) that would allow it to be relied upon by participants who do not in fact elect to defer beyond the year of vesting (or 2-1/2 months thereafter).

Discussion

A. The Definition of "Deferral of Compensation" – In General

Q&A 4(a) provides that a deferral of compensation occurs when a service provider has a legally binding right to compensation that is payable in a subsequent taxable year. There are numerous situations where a plan or arrangement could fail to comply with Section 409A even though the plan or arrangement was designed for legitimate, independent business reasons of the employer and was not intended to defer compensation, but nonetheless has the incidental effect of deferring compensation in operation (as presently defined in Q&A 4(a)). For example, many private companies maintain cash-based bonus and incentive plans that create legally binding rights within the meaning of Q&A 4(a) but under which payment of amounts otherwise fully earned and payable may be delayed if and to the extent necessary to ensure that the employer will have the cash flow necessary to satisfy other obligations, e.g., loan repayments. As a result, an employer could be faced with a difficult choice of either paying a bonus beyond the period permitted by the short-term deferral rule under Q&A 4(c) in violation of Section 409A, or paying it within such time period but violating other obligations (which it presumably would never do).

Another example involves bonus and incentive plans where the right to payment is conditioned on the occurrence of a future event related to the purpose of the payment, such as a liquidity event (e.g., either an IPO or sale of the company). Bonuses paid under a plan of this type would not satisfy the short-term deferral rule of Q&A 4(c) (unless the future contingency were deemed to constitute a "substantial risk of forfeiture"), and could be subject to the 20% additional tax and other penalties, even though the only purpose for deferring receipt of the bonus is to allow the amount of the bonus to be calculated or to condition its payment on the occurrence of an event unrelated to the service provider's deferral of taxation.

There are likely many other situations where legitimate business practices that have nothing to do with deferred compensation could be caught in the web of Section 409A, with arguably draconian results for employees. Until those other circumstances are identified, we think that there should be two express exceptions to the general rule of Q&A 4(a). *These would provide that a deferral of compensation does not occur if the employer or the affected employee can establish, by clear and convincing evidence, that (i) the payment of compensation is delayed because the employer has insufficient cash to make the payment and also satisfy its other legal obligations*[9] *and the deferral was not reasonably anticipated at the time the plan or arrangement was entered into, or (ii) the payment is conditioned on the occurrence of a future event beyond the control of the service provider and related to the purpose of the payment, such as the sale of a business or similar event. In the case of the delay attributable to the service provider's cashflow, if payment was made within the same taxable year as it would have been made, the "clear and convincing" evidence burden will be deemed to have been satisfied. The Service should reserve the right, by notice, to establish other circumstances that are deemed not to run afoul of Section 409A.* The "clear and convincing evidence" standard would be met by establishing that the plan or arrangement did not allow for *elective* deferral of compensation by the employee, and that any amounts *actually* deferred (within the meaning of Q&A 4(a)) were done for legitimate, independent and non-compensatory business reasons for the benefit of the employer.

9 We note that this circumstance continues to place employer compensation at risk of the employer's solvency, which was the express intent of Section 409A(a)(2)(B)(i) which delays payments to terminating key employees.

There is some precedent for an exception of this general type in other areas of the Code. For example, in regulations under Section 280G, payments made within one-year of a change in ownership or effective control of a corporation are presumed to be parachute payments, unless the taxpayer can rebut the presumption by clear and convincing evidence.[10] There is also precedent under Section 1.404(b)-1T of the Treasury Regulations, which deals with the treatment of deferred compensation for purposes of the timing of an employer's deduction. Q&A 2(b)(2) of that regulation gives examples of how a taxpayer may establish the impracticability of making a payment within the 2-1/2 month time period allowed under that regulation (e.g., where payment of such amounts within the applicable time period would jeopardize the solvency of the employer). Further, we believe that an exception of this type for specified situations, which puts the burden of proof on the taxpayer, should not create an opportunity for abuse. Rather, it would recognize that there are situations where payments may be made on a delayed basis for legitimate, independent business reasons for the benefit of the employer, having nothing to do with an intent to benefit the service provider by deferring the taxability of compensation. The standard currently in place could restrict customary and legitimate business practices and produce arguably draconian results for innocent employees under the Section 409A penalty provisions.

B. Certain Specific Proposals

1. Actual Short-Term Deferrals

While recognizing the utility of the short-term deferral rule in Q&A 4(c), we are concerned that the requirement that "at all times the terms of the plan require payment" within the applicable 2-1/2 month period will lead to many inadvertent compliance failures with unfair results. Indeed, we believe that application of the penalties in these circumstances will appear harsh in many situations and will inevitably give rise to lack of uniformity in the administration of these provisions.

Generally speaking, we are of the view that if payments are actually or constructively received by a service provider within the applicable 2-1/2 month time period set forth in Q&A 4(c), no deferral of compensation should be considered to have occurred even where the terms of the plan did not require that a non-deferred amount (i.e., an amount that was not elected to be deferred beyond the year of vesting (or 2-1/2 months thereafter)) must be paid by the end of the 2-1/2 month period. A good example involves programs that allow for the deferral of compensation, but under which some employees may elect not to defer. For example, an annual bonus program may provide that an employee can elect to defer his or her bonus. Payments made to employees who elect to defer compensation will have to be done in a manner compliant with Section 409A under an appropriately drafted bonus deferral plan. However, bonus payments to persons who do not elect to defer should be protected by the short-term deferral rule, as long as such persons receive their bonuses within the applicable 2-1/2 month period. Another example would be a plan (elective or non-elective) under which, as a result of the drafting of the plan, payments could theoretically be made well after the year of vesting, or a plan which, instead of providing for a default payment at the time of vesting with the right to elect to defer, happens to provide in an equivalent fashion for a future payment, with the right to elect an acceleration. So long as any payment made after the year of vesting (or more than 2-1/2 months after such year) would have to comply with Section 409A (in the former example), or any election to accelerate to the year of vesting (or 2-1/2 months thereafter) would have to be made in accordance with Section 409A, we see no abuse, and nothing to be gained by requiring that the plan have the provisions presently required by Q&A 4(c).

We would propose, therefore, a modification to Q&A 4(c), which would clarify that payments made to persons who do not elect to defer compensation under a plan or arrangement, even if that plan or arrangement otherwise allows for the elective deferral of compensation, will not constitute a deferral

[10] *See* Treas. Reg. § 1.280G-1 (Q&As 25, 26).

of compensation for purposes of Section 409A, provided that such payments are actually or constructively received by such persons within the applicable 2-1/2 month period allowed under the short-term deferral rule. We emphasize that any deferral beyond that time (or, in the case of an acceleration, any election to accelerate) would need to be effected in accordance with elections that comply with Section 409A.

2. Special Concerns for Multi-year Bonus Programs

Similarly, we suggest that Treasury and the Service consider another exception as part of the short term deferral exception that would be applicable to *multiple year bonus programs*. Q&A 4(c) requires that payment be made within 2-1/2 months after the year in which the service provider is no longer subject to a substantial risk of forfeiture. A multi-year bonus program will often provide for "vesting" in the performance bonus in the event of certain employment terminations prior to the end of the cycle, e.g., on account of death, disability or certain involuntary terminations. In these events, sometimes these vested payments are delayed until the end of the performance cycle, based on the actual achievement of the performance targets, and thus would result in the deferral of compensation for these individuals. We submit that this feature should not preclude the bonus program from qualifying for the short-term deferral exception for the vast majority of the other participants who do not benefit from the earlier vesting.

In considering the relief requested, we ask that Treasury and the Service bear in mind the severity of the penalties for noncompliance with Section 409A, as well as the burdens of compliance for small to medium-sized employers, many of whom do not have access to sophisticated legal counsel.

III. Special Issues Relating to Stock Options, Stock Appreciation Rights and Other Stock-Based Awards.

A. Exclusion for Stock Appreciation Rights Should Be Expanded

Proposal

We believe that stock appreciation rights should be excluded from Section 409A coverage on the same basis as stock options. Specifically the exclusion specified in Q&A 4(d)(iv) should be modified to read as follows (new text in italics):

> A stock appreciation right with respect to stock of the service recipient does not provide for a deferral of compensation if: (1) the value of the stock the excess over which the right provides for payment upon exercise (the SAR exercise price) may never be less than the fair market value of the underlying stock on the date the right is granted; *(2) either* (a) the stock of the service recipient subject to the right is traded on an established securities market, *or (b) any reasonable valuation method is used to determine whether, on the date the right is granted and the date the right is exercised, the requirements of clauses (1) and (3) of this sentence are satisfied with respect to the stock of the service recipient, including, for example, the valuation method described in Section 20.2031-2 of this chapter (Estate Tax Regulations); (3) the right may be settled upon exercise only by delivery of* (a) such stock of the service recipient, *(b) an amount of cash, or its equivalent, equal to the fair market value as of the exercise date of such stock of the service recipient for which the SAR is exercised as of the exercise date less the SAR exercise price for such stock, or (c) any combination of the foregoing forms of consideration;* and (4) the right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right. For purposes of the preceding sentence, the right to receive substantially nonvested stock (as defined in Section 1.83-3(b)) upon the exercise of a stock appreciation right does not constitute a feature for the deferral of compensation. If,

under the terms of the stock appreciation right, the SAR exercise price is or could become less than the fair market value of the underlying stock on the date of grant, or there is an agreement or arrangement under which the service recipient will purchase the stock delivered in settlement of the right upon exercise in exchange for a payment in excess of the fair market value of such stock on the date of such purchase, then the grant of the stock appreciation right may provide for the deferral of compensation within the meaning of this section.

Discussion

Section 409A does not specifically address SARs, and the Conference Report does not include SARs in the list of the types of equity-based compensation that are not subject to Section 409A. Rather, the Conference Report states that Treasury may address in regulations issues relating to stock appreciation rights.[11]

Unlike some of the improper arrangements meant to be addressed by Section 409A, we do not think that stock options and SARs are inherently abusive. Most stock options and SARs are used appropriately to motivate employees and other service providers by providing them with incentive compensation tied to the increase in value of their employer's or service recipient's stock. Further, as described in greater detail below, the income tax consequences of stock options and SARs are well established and do not generally present opportunities for the types of improper deferral of income described by Congress as the reasons for the changes enacted by Section 409A. We do not believe that Section 409A was intended by Congress to curtail the legitimate use of stock options or SARs in the ordinary course. Therefore, administrative exclusions from Section 409A for stock options and SARs should be broadly drawn. We agree that the exclusion of stock-settled SARs of public corporations is appropriate, but also believe that a more general exclusion of SARs from Section 409A does not raise significant Section 409A avoidance concerns, preserves the currently similar tax treatment of options and SARs and is appropriate for non-tax reasons.

Notice 2005-1 states that the grant of an SAR generally provides for a deferral of compensation subject to Section 409A. Notice 2005-1 generally provides that whether SARs are covered by Section 409A depends upon whether they are settled in cash or stock and whether the stock is stock of a public or private corporation.

Notice 2005-1 provides that the grant of stock-settled SARs is exempt from Section 409A if (i) the exercise price is never less than the fair market value of the underlying stock on the date the right is granted, (ii) the stock subject to the right is traded on an established securities market, and (iii) the right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right. Notice 2005-1 also provides that the grant of an SAR may be covered by Section 409A if there is an agreement or arrangement under which the employer will purchase the stock delivered on exercise of the SAR. Also, to be exempt from Section 409A, the SAR must relate to stock of the recipient's employer or a member of its controlled group under Section 414(b) or (c).[12]

In addition, Notice 2005-1 provides that, until further guidance is issued, SARs (whether settled in stock or cash) are not subject to Section 409A if (i) the right is granted pursuant to a program in effect on or before October 3, 2004, (ii) the exercise price is never less than the fair market value of the underlying stock on the date the right is granted and (iii) the right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right.

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[11] Conf. Rep. at 525.

[12] Q&As 4(d)(iv), 5.

Notice 2005-1 generally exempts the grant of nonstatutory stock options from the requirements of Section 409A if they satisfy certain conditions, including that the exercise price is at least equal to the fair market value of the underlying stock on the grant date of the option. As observed in the preamble of Notice 2005-1, "under certain conditions, stock appreciation rights yield economically equivalent results to nonstatutory stock options exercised in a cashless transaction." It is our understanding that many employees of public corporations use broker-assisted cashless exercise procedures to exercise their stock options, which generally allow the employee to receive the benefit of the option without using his or her own funds to pay the exercise price. We further understand that many employees using a cashless exercise procedure elect to receive the "spread" on their options in cash, rather than receiving actual shares. The economic result from the employee's perspective of exercising an option using such a cashless exercise procedure is identical to the economic result of exercising an SAR for cash.[13]

Under existing law, the income tax consequences of SARs have been governed by Section 451 and the doctrine of constructive receipt. Revenue Ruling 80-300, amplified by Revenue Ruling 82-121, provides that the forfeiture of a valuable right is a substantial limitation that precludes constructive receipt of income. In the case of an SAR, the employee's right to benefit from further appreciation of the stock without risking any capital is a valuable right.[14] Therefore, the employee who receives SARs is not in constructive receipt of income by virtue of the appreciation of the employer's stock.[15] Treasury's long-standing position has been that the cash payment to which the employee is entitled under the SAR is includible in the employee's gross income in the year the SAR is exercised. The income tax consequences of SARs, described above, have historically been essentially the same as those of options, i.e., recognition of ordinary income by the employee (and a corresponding deduction by the employer) when the SAR or option is exercised in the amount of the then-current "spread" on the underlying stock.

Stock options and SARs are treated similarly for purposes of other provisions of the Code. Both stock options and SARs, which are granted with a fair market value exercise price, receive special treatment under Section 162(m). Specifically, the regulations provide that such stock options and SARs are deemed to satisfy the performance goal requirement of Section 162(m) simply by virtue of the fact that "the amount of compensation the employee could receive is based solely on an increase in the value of the stock after the date of the award."[16] Options and SARs are both excluded from the definition of nonqualified deferred compensation for purposes of Section 3121(v)(2).[17]

There are significant non-tax reasons why employers may wish to use SARs instead of options to compensate their employees. First, until recently, stock options granted to employees with an exercise price at least equal to the fair market value of the underlying stock on the grant date generally did not result in a charge to the issuer's earnings for accounting purposes. Many employers are now adopting accounting practices that entail recognition of expenses associated with compensatory options and may be required by recent changes in accounting rules to adopt the expensing of options in the near future. Accounting principles have always required earnings charges with respect to SARs. Because options and

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13 In fact, we understand that most employers would have long ago used SARs rather than options but for the unfavorable financial accounting treatment associated with SARs vis-à-vis options.

14 *See*, *e.g.*, PLR 8949032 (Sept. 8, 1989).

15 PLR 8642025 (July 16, 1986) states that the need to forfeit the right to future appreciation on the stock to which the SAR relates will be a substantial limitation that precludes constructive receipt of income from appreciation of the stock, prior to exercise of the SAR, provided that the base price of the SAR is equal at least to the fair market value of the stock at the grant date of the SAR.

16 Treas. Reg. § 1.162-27(e)(2)(vi)(A).

17 Treas. Reg. § 31.3121(v)(2)-1(b)(4)(ii). The significance of the Section 3121(v)(2) regulations to the present discussion of Section 409A is readily apparent in that the terms "deferral of compensation" and "legally binding right" used in Q&A 4(a) are nearly identical to the meanings given such terms in Section 31.3121(v)(2)-1(b)(3)(i) of the Treasury Regulations.

SARs are or may soon be on a similar footing from an accounting perspective, and SARs may result in less dilution of stockholders' equity, SARs have been anticipated to be used to compensate employees to a greater extent than had historically been the case. Second, privately held corporations, including subsidiaries of publicly held corporations, often use SARs to limit or restrict ownership of their stock, for example to comply with applicable securities laws or to restrict ownership of the corporation only to certain persons. Third, some employers use SARs in jurisdictions where stock options are not feasible or are inappropriate due to local laws or compensation or corporate practices. SARs may be used in these situations instead of stock options because SARs, like stock options, provide the holder with a benefit based on the increase in the value of the underlying stock during the period from the grant date to the exercise date and allow the holder to control the time when such benefit will be paid by choosing when to exercise the SAR. If an SAR were subject to Section 409A, it appears that the only way the SAR could comply would be either to limit its exercise to only those distribution events permitted by Section 409A or to defer its settlement until the occurrence of one of those events.[18] This would basically eliminate the usefulness of SARs as an alternative to stock options because the economic consequences of such Section 409A compliant SARs would be significantly different from those of options.

The Section 409A exemption for stock-settled SARs of public corporations is appropriate because the value of the deferred compensation obligation is determined solely by the change in the fair market value of stock, as determined by the securities markets, which provides an objective standard, generally not subject to manipulation. We believe, especially in light of the considerations discussed above, that this analysis applies equally to cash-settled SARs that are tied to the value of the stock of a public corporation.

We understand and appreciate Treasury and Service concern that SARs with respect to non-public corporation stock may raise concerns that are absent in the public corporation context due to the reduced objectivity inherent in the valuation of equity interests in non-public entities.[19] Nevertheless, we believe that the foregoing reasons for excluding public corporation SARs from the coverage of Section 409A support with equal force a similar exclusion for SARs on private corporation stock if the stock underlying the private corporation SAR is fairly valued.[20] We note that these same valuation issues arise in the case of private corporation nonstatutory stock options and the grant of restricted stock, but Notice 2005-1 nevertheless excludes such options and restricted stock from the coverage of Section 409A if the requirements of Q&A 4(d)(ii) are satisfied.[21] Accordingly, Notice 2005-1 recognizes that stock of a corporation is capable of being fairly valued not solely by reference to the price determined by an established securities market. Notice 2005-1 permits corporations to use any reasonable valuation method to determine the fair market value of stock on the grant date of a nonstatutory stock option, such as the valuation method described in Section 20.2031-2 of the Treasury Regulations.[22] We think that the

[18] For example, Q&A 4(d)(i) states "the terms of a stock appreciation right with a fixed payment date generally will comply with the provisions of § 409A."

[19] Notice 2005-1 does not address the situation where the stock subject to the SAR is traded on an established securities market when the SAR is granted but ceases to be so traded after grant.

[20] For example, private corporation SARs, if excluded from the rules of Section 409A, could be used to provide disguised deferred compensation by setting the exercise price at an inappropriately low amount, so that the value of the SAR includes a compensatory element in addition to the true increase in value of the underlying stock after the grant date of the SAR. A similar avoidance of Section 409A could be achieved by attributing an excessive value to the stock when the SAR is exercised.

[21] The Conference Report (page 524) similarly specifically excludes from coverage by Section 409A stock options with exercise prices not less than the fair market value of the underlying stock on the grant date if there is no deferral feature other than the option holder's right to exercise the option in the future.

[22] The statutory stock option regulations similarly provide that any reasonable valuation method may be used to determine whether, at the time the option is granted, the option price satisfies the pricing requirements of Sections 422(b)(4), 422(c)(5), 422(c)(7) and 423(b)(6) with respect to the stock subject to the option,

exclusion of SARs from Section 409A coverage should apply these same standards to the determination of the fair market value of stock, which is not traded on an established securities market, underlying the SAR on the grant and exercise of the SAR.

B. <u>Transitional Issues For SARs</u>

The application of Section 409A to SARs is controversial, and the statute and applicable legislative history are unclear as to whether an extension of Section 409A to SARs merely by virtue of the SAR's structure is necessary or appropriate to redress perceived abuses in practices relating to true nonqualified deferred compensation. Treasury and the Service thoughtfully recognized that the effect of Section 409A on SARs could be both harsh and surprising, and in light of the need better to understand the manner in which SARs operate in the context of what Section 409A was intended to address, Q&A 4(d) states that, until further guidance is issued, an SAR, if granted pursuant to a "program" "in effect" on or before October 3, 2005, will not be treated as involving deferred compensation, provided that the SAR is not in the money at grant, and that no other deferral feature is included.

We understand that some consideration is being given to taking a restrictive view of this transition relief in several ways. First, as to whether the "program" exists at all or is "in effect" at any particular time even though SARs are authorized under a plan, but there is no pattern of grants. In addition, we understand that some consideration is being given to viewing this relief as temporary and subject to retroactive elimination (albeit with a transitional period to unwind any SAR), rather than viewing the relief as a true grandfather provision.

We believe here that a straightforward interpretation of the transitional relief in Q&A 4(d) would be appropriate. If an employer had a plan in effect before October 4, 2004, that permitted the grant of SARs, then we submit that it should be able make grants thereunder of SARs not having a strikeprice below grant date fair market value regardless of the extent to which SARs were used in the past.

C. <u>Option Valuation Methods Based on Public Prices</u>

We appreciate that Treasury and the Service have has been concerned that options and SARs may be used as a mechanism to provide deferred compensation, and concur with the approach adopted in Notice 2005-1 of exempting them from Section 409A only if, among other things, they are not issued at a discount. Q&A 4 provides that any reasonable valuation method may be used for such purposes, including for example the valuation method described in Section 20.2031-2 of the Treasury Regulations. The Regulations applicable to statutory options in effect provide for stated safe harbors in connection with the establishment of the fair market value of stock for which there is a market, based on average selling prices over extended periods of as much as a week.[23]

We also believe that options are not at the core of what was being addressed by Section 409A, and that options should be the subject of additional regulation only to avoid abusive deferral practices disguised as options. Accordingly, we suggest that any reasonable valuation methodology for a publicly traded stock based on the public prices of the security in question should be expressly considered acceptable for purposes of Section 409A. (We intend no negative inferences regarding what should be considered acceptable for other purposes, and believe that any favorable guidance on this point should be clear that no such negative inferences should be drawn.) In those cases in which there is recurring practice, the methodology should have to be consistently applied, although the foregoing should not be

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including, for example, the valuation method described in Section 20.2031-2 of the Treasury Regulations. Treas. Reg. § 1.421-1(e)(2).

23 Treas. Reg. §§ 1.421-1(e), 1.422-2(e)(1), 20.2031-2(b)(1); *see also* Treas. Reg. § 1.424-1(a)(9).

applied so as to limit an employer's ability to change methods prospectively for legitimate business purposes, and should not be applied to constrain the design of one-off grants where the design is motivated by legitimate business purposes. At a minimum, there should be express approval of valuation methodologies that are required by, or based on, local, non-U.S. regulatory schemes or that are otherwise customary in a particular geography or industry. Possibly, if Treasury and the Service think necessary, a savings provision could be added requiring that a principal purpose of the option and the related valuation methodology not be to effect the deferral of compensation to avoid Section 409A.

D. Expand (Liberalize) "Service Recipient" Condition for Option and SAR Exclusion from Section 409A

Proposal

We recommend that the "service recipient" condition for the exclusion of nonstatutory stock options and SARs from Section 409A be relaxed so as to extend to any reasonable service relationship in the case of operating and certain other entities, and so that a 30% level of affiliation would also be considered sufficient to establish an alternative appropriate nexus.

Discussion

Notice 2005-1 provides that nonstatutory stock options and SARs are not subject to Section 409A if they meet certain requirements and relate to stock of a "service recipient."[24] Notice 2005-1 defines a service recipient to include only the person for whom services are performed and all others who would be included with this person under Section 414(b) or (c).[25] Section 414(b) and (c) generally require ownership levels of 80% or higher throughout a parent-subsidiary chain or at least 80% ownership consolidated in five or fewer individuals, estates or trusts.[26] Accordingly, the specific exclusions from coverage by Section 409A for certain nonstatutory stock options and SARs contained in Notice 2005-1 do not appear to be available to options or SARs granted by an issuer to an employee or other service provider who is not employed or retained by a member of the issuer's controlled group within the meaning of Section 414(b) or (c).

Section 83 governs the income tax consequences of the transfer of property in connection with performance of services. "Property," as used in Section 83, is not limited to stock, and certainly not limited to stock of the employer or other service recipient or a corporation that has a specified ownership relationship to the employer or other service recipient.[27] Section 1.83-7 of the Treasury Regulations describes how Section 83 applies to an option[28] to which Section 421 (relating to statutory stock options) does not apply. Assuming the option does not have a "readily ascertainable fair market value" (within the meaning of Section 1.83-7(b) of the Treasury Regulations) at the time of grant, Section 83(a) and (b) apply to the transfer of property that occurs when the option is exercised or disposed of. Accordingly, the optionee generally recognizes taxable ordinary income at the time his or her option is exercised or

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24 Q&A 4(d)(ii), (iv).

25 Q&A 5.

26 Treas. Reg. §§ 1.414(c)-2, 1.1563-1.

27 *See* Treas. Reg. § 1.83-3(e).

28 Neither Section 83 nor the regulations thereunder define the term "option," and there is no particular form of words necessary to create an option. However an option is generally understood to be a contract that expresses an offer to sell property at a specified price for a stated period of time, with the offeree being under no obligation to purchase the property. PLR 199931044 (May 6, 1999), PLR 9732007 (May 1, 1997). Further, the substantive provisions of Section 1.83-7 of the Treasury Regulations are not limited to options to purchase "stock" (although the title of this section is "Taxation of nonqualified stock options").

disposed of in the amount of the fair market value of the property received (determined on the date of exercise or disposition) less any option exercise price paid.[29]

As noted above, in order for Section 83 to apply, property must be transferred "in connection with the performance of services." This implies a cause-and-effect relationship between the services rendered and the transfer of property. Whether property is transferred in connection with the performance of services is determined by the "predominant purpose" of the transfer.[30] It has been held that the following factors are considered in determining whether property is transferred in connection with the performance of services: (i) whether the property right is granted at the time the employee or independent contractor becomes employed or otherwise associated with the employer; (ii) whether the property restrictions are linked explicitly to the employee's or independent contractor's tenure with the employing company; (iii) whether the consideration furnished by the employee or independent contractor in exchange for the transferred property is services; and (iv) the employer's intent in transferring the property.[31]

Under the well-developed body of law governing the application of Section 83 to nonstatutory stock options, the extent of affiliation between the issuer of stock subject to an option and the employer of the optionee is not directly relevant to whether or not Section 83 applies to the optionee's receipt and exercise of the option. We note that the Conference Report appears to depart from this traditional interpretation by stating that the term "nonqualified deferred compensation" is not intended to include "an arrangement taxable under section 83 providing for the grant of an option on <u>employer</u> stock …" [emphasis added]. One explanation of this statement may be that Congress intended to distinguish traditional, services-related employer stock options from more esoteric options granted on mutual fund shares or other similar securities of entities having no connection to the service relationship. It would appear reasonable to us to read the reference to "employer" stock options as a short-hand way to permit options having a nexus to the service relationship.[32]

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29 Treas. Reg. § 1.83-7(a).

30 *See*, *e.g.*, TAM 9737001 (May 23, 1997) (stock and options transferred by the producer of a television show to cable broadcasters to induce them to carry the show held not to be transferred in connection with the performance of services, where the "services" in question would have been performed by the cable broadcasters in connection with their business of providing cable services to their customers whether or not the cable broadcasters had engaged in the arrangement with the producer, and that the predominant feature of the transaction was access to a cable channel); Treas. Reg. § 1.83-3(f) (Section 83 may not apply to an employee's purchase of stock from the employer if the purchase is made on the same terms as the employer offers to persons other than employees in a private or public offering); *Centel Communications Co. v. Comm'r*, 92 T.C. 612 (1989), *aff'd*, 920 F.2d 1335 (7th Cir. 1990) (options granted by a corporation to three shareholders who guaranteed corporation's bank loans were not in connection with the performance of services because guarantees "were essentially an assumption of additional financial risk . . . in [the guarantor's] role as shareholders or investors . . . to protect their investment"); *Oregon Metallurgical Corp. v. U.S.*, 87-2 USTC ¶ 9388 (Cl. Ct.) (stock options transferred to compensate a corporation for guaranteeing a bank loan to the transferor do not qualify for Section 83 deduction); TAM 200043013 (Oct. 27, 2000) (in general, when warrants are transferred to a lender in connection with the giving of credit, they are transferred to compensate the lender for making the loan and not for "services"); *Rupprecht v. U.S.*, 11 Cl. Ct. 689 (1987) (in the cash-out of a target company's employee stock options by the acquiror in connection with a corporate transaction, Section 83 applies to the cash received by the employees for cancellation of their options).

31 *Aidoo v. Comm'r*, T.C.Memo 1993-28.

32 We also note that Section 409A(d)(6) provides that, for purposes of Section 409A, rules similar to the rules of Section 414(b) and (c) shall apply, except as provided by Treasury. The Conference Report (page 525) explains that this is intended to prevent avoidance of Section 409A. Even if these employer aggregation rules were applicable to an exclusion from the coverage of Section 409A, this provision expressly authorizes Treasury to not apply the rules of Section 414(b) and (c). We do not think that the employer

Statutory stock options provide optionees with special tax benefits.[33] Statutory stock options can be granted only to employees of the issuer or other corporations in an unbroken parent-subsidiary chain based on ownership levels of 50%.[34] Statutory stock options appear to reflect a legislative purpose of using employee stock ownership to encourage commitment to a company and its future.[35] At the same time, all stock options dilute stockholders' equity. The limitation of statutory stock options to employees of the issuer and corporations with a 50% or greater parent-subsidiary relationship with the issuer appears to be aimed at limiting the tax benefits of statutory stock options to those employees whose work may be expected to directly or indirectly benefit the issuer and its shareholders. Section 409A, by contrast, is a penalty provision, apparently intended to deter nonqualified deferred compensation arrangements that Congress considers abusive. We do not believe that any discernable policy is advanced by (and no provision of Section 409A or the Conference Report requires) making the exemption of nonstatutory stock options from the Section 409A penalty subject to conditions more restrictive (an 80% controlled group test) than the conditions for the tax benefits of statutory stock options (a 50% parent-subsidiary test). Nor do we believe that any discernable policy is advanced by limiting this exemption for nonstatutory stock options by the 50% parent subsidiary test applicable to statutory options.

It is quite common for a corporate parent to conduct business through subsidiaries or joint ventures and to compensate employees of those subsidiaries or joint ventures with options on the parent's stock, without any necessary regard to the degree of the parent's ownership of the subsidiary or joint venture. Further, a corporation may own less than 50% of a multiparty joint venture and for valid business reasons want to grant options on its stock as compensation to employees of the joint venture. Additionally, the terms of a corporate transaction may result in employees of one of the parties to the transaction holding options to purchase stock in a corporation that is not affiliated with their employer after the transaction. For example, Revenue Ruling 2002-1 describes the tax effects of a spin-off transaction on nonstatutory stock options. In this ruling, an employee of a distributing corporation and an employee of its subsidiary each hold an option to purchase distributing corporation stock. After the subsidiary is spun off, such option is cancelled and replaced with an option to purchase stock of the distributing corporation and an option to purchase stock of the former subsidiary. Even though following the spin-off some of the options held by each optionee are on stock of a corporation unrelated to the optionee's employer, the ruling states that the optionees recognize income under the rules of Section 83 when they exercise their options. More generally, as business structures reasonably evolve to meet market and regulatory demands, there are a growing number of legitimate uses of options to compensate service providers who may or may not have a direct employment relationship with the issuer. As just one example of the many nonabusive services-related structures that are possible, services may be provided to an entity by another service-providing entity, in circumstances in which the parties may wish as a business matter to compensate the employees of (and other service providers to) the service-providing entity with equity interests in the ultimate service recipient, notwithstanding that such employees' (and other service providers') services happen not to be provided directly to the ultimate service recipient.

In conclusion, there are myriad situations in corporate practice that can result in optionees holding nonstatutory options on stock of a corporation that does not bear any particular minimum level of affiliation with the optionee's employer, but where there is a clear services relationship between the

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aggregation rules of Section 414(b) and (c) should be applied as part of an exemption for nonstatutory stock options because, as more fully explained herein, the mere fact that a nonstatutory stock option is granted by an issuer outside the employer's Section 414(b) and (c) controlled group is not itself likely to present an opportunity for avoidance of Section 409A.

33 In general, the exercise of a statutory stock option is exempt from income tax subject to certain conditions and limitations. *See generally* § 421.

34 §§ 422(b), 423(b), 424(e), 424(f).

35 *See* H.R. Rep. No. 749, 88th Cong., 1st Sess. at 64.

grantor and the grantee. The income tax consequences of such compensatory options in these situations are governed by long-standing income tax rules under Section 83. We have not found any indication of abuse relating to these arrangements that Section 409A was intended to address. Accordingly, the requirement that options be subject to Section 409A unless they satisfy the "service recipient" limitation of Notice 2005-1 seems overly restrictive, and we believe that (i) the general rule should be that there be no minimum required ownership relationship between the issuer and the entity to which the grantee directly provides his or her services, if the issuer is the ultimate recipient of the grantee's services, and (ii) in addition, where an effective indirect services relationship from the grantee to the issuer cannot be established, there would also be the ability to grant interests in certain affiliates without implicating Section 409A concerns. Thus, we urge that this condition to the exclusion of nonstatutory stock options generally be eliminated where (i) there is any direct or indirect services relationship between the grantee and the entity in which the option is granted, or (ii) there is at least a 30% ownership relationship, such relationship being formed if 30% replaced 80% for purposes of the application of Section 414(b) and (c). As to the ownership test, we think that the 30% ownership threshold, which would apply where the services relationship may be difficult to establish, as in the case of an interest in a joint venture, represents a meaningful level of ownership that warrants the treatment of the option as such, rather than the treatment of the option as deferred compensation subject to Section 409A. Because, as discussed above, SARs are the virtual economic equivalent of options (and historically have had income tax consequences that are virtually the same as those of options), the exclusion of SARs from the coverage of Section 409A should similarly not be conditioned on the SAR being issued by an entity that has a specified minimum level of affiliation with the SAR recipient's employer.

We recognize that the above rule, especially to the extent not requiring any ownership relationship, might permit the granting of options and SARs in respect of securities in passive investment vehicles, to employees and other service providers of managers and other affiliates. Even where the option or SAR is not granted at a discount, then the rule permitting any grants in the context of a services relationship with the issuer could be limited to (i) grants of options on securities of bona fide operating companies (including a parent company) as defined for purposes of Section 1042 (or possibly some other reference point) and (ii) grants of options on securities in certain tax-preferred vehicles that have characteristics which are likely to cause the grants to have predominantly customary, rather than abusive, characteristics.

For example, the REIT rules are intended to provide tax incentives for the establishment and operation of REITs. We think that a rule which would prevent options on REIT shares from being granted to employees of the REIT management company and other affiliate employees would place externally managed REITs at a significant competitive disadvantage to self-managed entities, as a result of legitimate choices regarding business structure not related to compensation decisions. We ask that Treasury and the Service consider these matters carefully so as to avoid unnecessary market disruption in industries where the unfettered use of options and SARs to compensate indirect service providers is not inconsistent with the fundamental policies underlying Section 409A.

E. <u>Certain Post-Grant Changes to Options and SARs Do Not Violate Section 409A</u>

<u>Proposal</u>

We believe that rules concerning changes to outstanding stock options and SARs (other than in connection with a corporate transaction) that could affect their exclusion from Section 409A should provide that:

- Any change in the terms of an option or SAR, which is excluded from Section 409A at the time of grant, or other action, that accelerates the time at which, or conditions under which, such option or SAR may be exercised will not subject such option or SAR to Section 409A. (This result is consistent with the treatment of statutory options under current law.)

- The rules developed relating to post-grant modifications of options and SARs should permit a modification that merely tolls the exercise period of the option or SAR for the time that the holder is prohibited by any law, regulation or rule from exercising the option or SAR if (i) the option or SAR would have otherwise expired during such black-out and (ii) the extension of the exercise period is not beyond 2-1/2 months after the end of the calendar year in which the black-out began. We expressly note that there may be other circumstances the Treasury and the Service may want to consider under which an extension of the exercise period may be permitted (assuming that the extension is not provided in consideration of the service recipient's forbearance of other compensation unrelated to the option or SAR).[36] We also recommend that consideration be given to implementing some of the modification rules only on a prospective basis.

Discussion

As discussed above, Notice 2005-1 provides that the grant of stock options and certain SARs are not subject to Section 409A if they meet certain requirements.[37]

Acceleration of the time or schedule of any payment under a plan violates Section 409A except as provided by Treasury in regulations.[38] However, it is not an acceleration of the time or schedule of payment of a deferral of compensation if the service recipient waives or accelerates the satisfaction of a condition constituting a substantial risk of forfeiture so long as the other requirements of Section 409A are satisfied.[39] For example, where a nonqualified deferred compensation plan provides for a lump-sum payment of the vested benefit upon separation from service, a reduction of the vesting requirement from 10 years of service to five years of service is not a violation of Section 409A.

We believe that the relief described above does not open the door to the abuse perceived in the grant of discount options. Thus, we submit that the regulations should clarify that any change in the terms of an option or SAR to accelerate the time at which such option or SAR may be exercised does not result in a violation of Section 409A.[40] Section 424(h)(3)(C) provides that a change in the terms of an option to accelerate the time at which the option may be exercised does not constitute a modification of the option. A modification of a statutory stock option is considered the granting of a new option, which may not satisfy the requirements of Section 422 or Section 423 when the option is modified (and considered newly granted). If these requirements are not satisfied, no penalty is imposed on the optionholder other than loss of the special tax benefits accorded statutory stock options.[41] By contrast, if a nonstatutory stock option or SAR does not satisfy the requirements for the administrative exemption from Section 409A, and such option or SAR does not otherwise comply with Section 409A, significant and most likely unexpected penalties would be imposed by Section 409A(a)(1) on the holder of such

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36 Our suggestions should not be interpreted as implying that we view these circumstances as the only ones where an extension should be considered permissible under Section 409A.

37 Q&A 4(d).

38 § 409A(a)(3).

39 Q&A 15(a).

40 We note that Q&A-15(a) should be interpreted to provide for this result.

41 An option that does not satisfy the requirements of Section 422 or Section 423 is taxed as a nonstatutory stock option under Section 83 and Section 1.83-7 of the Treasury Regulations.

option or SAR. *Accordingly, we ask that Treasury and the Service carefully consider which requirements imposed on statutory options should be used for purposes of Section 409A.*.[42]

We think that there are certain circumstances where post-grant modifications of excepted options or SARs should not affect the exception from 409A. In particular, there are an increasing number of situations where, due to regulatory considerations, issuers of options or SARs may preclude the grantee from exercising them. For instance, it may be a violation of applicable securities laws for the issuer of an option to allow its exercise while the issuer is considering a restatement, or has delayed the public filing, of its financial statements. We think it appropriate in these types of circumstances to permit the tolling of the exercise period for the time that the holder is prohibited from exercising the option or SAR if (i) the option or SAR would have otherwise expired during the black-out period and (ii) the extension of the exercise period is not beyond 2-1/2 months after the end of the year in which the black-out began. We expressly note that there may be other circumstances the Treasury and the Service may want to consider under which an extension of the exercise period may be permitted (assuming that the extension is not provided in consideration of the service recipient's forbearance of other compensation unrelated to the option or SAR).[43]

In addition, regarding transition relief for options and SARs, we note that many option and SAR plans and agreements will pre-date the enactment of Section 409A. To the extent that modifications of outstanding awards would jeopardize their exempt status under Section 409A if the change were not provided for ab initio, we think that Treasury and the Service should provide a grace period during which certain changes would be permitted to be made. For example, while some option arrangements expressly provide for extended exercise periods after employment termination on account of retirement, many do not but the employer may have a general practice of providing such extensions on an ad hoc basis; we think it would be appropriate in such circumstances to permit the employer to consider formalizing that practice by amending plan documents without jeopardizing the status of outstanding options under Section 409A.

F. <u>Dividend Equivalents Paid Contemporaneously With Cash</u>

<u>Proposal</u>

An employee's (or other service provider's) contractual right to receive an amount determined by reference to regular cash dividends that the company declares and pays on a specified number of shares of stock, which the employee (or other service provider) does not actually own, is commonly referred to as a dividend equivalent right. Dividend equivalents may be paid in cash or stock.

Guidance concerning Section 409A should provide that the grant of a dividend equivalent right that is paid at the time cash dividends are paid to stockholders of the company does not violate Section 409A.

<u>Discussion</u>

A dividend equivalent right is not "property" within the meaning of Section 83.[44] Accordingly, the receipt of a dividend equivalent right is not a taxable event. The holder of a dividend equivalent right

[42] This portion of the report does not apply to an adjustment of an option in connection with a corporate transaction. The adjustment of options in corporate transactions is discussed in Section IV of this report.

[43] *See also* footnote 36 above.

[44] For purposes of Section 83, the term "property" does not include an unfunded and unsecured promise to pay money or property in the future. Treas. Reg. § 1.83-3(e).

recognizes taxable income in the amount of cash or the fair market value of other vested property received under the dividend equivalent right.

Notice 2005-1 provides that the grant of equity-based compensation generally provides for a deferral of compensation subject to Section 409A.[45] Notice 2005-1 states that a stock appreciation right with a fixed payment date generally will comply with Section 409A. Similarly, a dividend equivalent right that gives the holder the right to receive on fixed periodic dates (e.g., quarterly or annually) payments in the amount of all cash dividends paid on a specified number of shares of stock generally should comply with Section 409A.[46]

Deferred compensation denominated in stock of a company is meant to provide the holder with the economic equivalent of actual stock ownership.[47] A dividend equivalent right provides the holder with the economic effect of a stockholder's right to receive cash dividends. A stockholder has no right to receive a dividend unless and until the company's board of directors declares the dividend. The payment of a dividend equivalent at the time cash dividends are paid to the company's stockholders is subject to a condition within the control of the company. The holder of such dividend equivalent right has no legally binding right to payments thereunder until the company declares a dividend and so does not seem to provide for a deferral of compensation in the ordinary sense of those words.

Whether or not the holder of a dividend equivalent right is deemed to have deferred compensation at the time the right was granted, we think that Treasury and the Service should adopt a rule of convenience under which dividend equivalents that are paid in the same taxable year (or within 2-1/2 months thereafter) as regular cash dividends are declared and paid to the company's stockholders do not provide for a deferral of compensation. The payment of dividend equivalents at the time cash dividends are paid to stockholders mirrors the economic effect of actual stock ownership and is administratively convenient. Further, we submit that such an arrangement does not result in an improper deferral of income because dividend equivalent payments are received by and taxed to a holder of the dividend equivalent in the same taxable year (or within 2-1/2 months thereafter) as actual cash dividends are received by and taxed to the holder of the same number of shares of stock. The potential for abuse is further restricted, if not eliminated, by the fact that the timing and amount of the dividend equivalent payment is determined by an event having legal and economic significance independent of the dividend equivalent right, i.e., the payment of cash dividends to the company's stockholders. We believe that Treasury and the Service have a basis for adoption of such a rule of convenience, which is quite similar to the short-term deferral exclusion of Q&A 4(c). Additionally, as explained above, a dividend equivalent right with a fixed payment date generally complies with Section 409A. Payment of dividend equivalents at the time cash dividends are paid to stockholders of the company, instead of on such fixed payment dates, may be viewed simply as an acceleration of such payments. Section 409A(a)(3) expressly authorizes Treasury to provide in regulations exceptions to the general prohibition on acceleration of the time or schedule of any payment under a plan.

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45 Q&A 4(d)(i).

46 Dividend equivalent payments that are deferred and paid upon any payment event specified in Section 409A(a)(2)(A) should comply with Section 409A. For example, restricted stock units that are paid, together with accrued dividend equivalents, on a fixed payment date should comply with Section 409A.

47 A recent private letter ruling concerning restricted stock units that entitled the holder to receive dividend equivalent payments states: "A grant of a restricted stock unit is the economic equivalent of a grant of a restricted share of common stock that is subject to the same forfeiture conditions and transfer restrictions." PLR 200406026 (Nov. 3, 2003); s*ee also* PLR 200449012 (Aug. 12, 2004).

G. Timing of Elections in Respect of New Grants of Stock-Based Awards Subject to Vesting

Proposal

Where a service recipient grants stock-based compensation that is subject to Section 409A (e.g., certain restricted stock units) that have a post-grant vesting period of at least one year, we recommend that a participant be allowed to make any initial elections that may be permissible under such grant within 30 days of the date of grant.

Discussion

Under Section 409A(a)(4)(B)(i), a plan must generally provide that compensation may be deferred only if the election to defer such compensation is made not later than the close of the taxable year before the year in which such compensation is earned or at such other time as provided in regulations. We think it would be appropriate for guidance to allow the service provider a 30-day period following his or her being notified of the grant of the stock-based award during which to make an election where the award has a vesting period of at least one year from date of grant. The approach outlined above is consistent with the principle that, where there is an extended vesting period of at least one year, the compensation in question may be considered to have been earned in certain respects during the years of vesting.[48]

The extended vesting period creates a sufficient gap between the time of election and the time of vesting such that there is little risk of an abusive acceleration of payment or other manipulation of constructive-receipt principles. Further, the 30-day window suggested is consistent with the period during which a participant may make an election in his or her first year of eligibility to participate in a plan under Section 409A(a)(4)(B)(ii). Section 409A(a)(4)(B)(i) on its face gives Treasury the right to establish permissible election dates in its discretion. We note that these considerations are particularly critical in connection with grants of restricted stock units and other deferred equity grants that are subject to vesting requirements because it is often unclear over what period they may be "earned" and prior to which deferral elections would have to be made. For example, some companies may base the level of grants on prior year's performance, in a manner similar to the award of a cash bonus; however, the deferred vesting of the award distinguishes such grants from regular cash bonuses.

In this context, as in the case of other mandatory deferred compensation, it will be important to specify the terms of this first election. A participant's initial election to defer compensation and a subsequent election to defer compensation previously deferred have different requirements under Section 409A. The Code does not address expressly the issue of whether an election that follows a mandatory deferral (e.g., where the employer requires that a portion of compensation be deferred) is treated as an initial election or a subsequent election. Section 409A(a)(4)(C) places specific requirements on the terms of a "subsequent election" which differ from those of an initial election. It is important that guidance be provided as to the nature of an election which is made with respect to compensation which had been deferred without an initial election by the participant (e.g., as mandated by the sponsor). The regulations should confirm that an election following a mandatory deferral should qualify as a subsequent election even though the participant never had an opportunity to make an initial deferral election. The same should hold true where the plan establishes default choices and the participant did not make an affirmative election within the proper time period. These clarifications would make it clear that a service

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48 Conceptual support for this rule can be found under the rules governing the application of Sections 404(b) to short-term deferrals. *See* Treas. Reg. § 1.404(b)-1T (Q&A 2); TAM 199923045 (Oct. 9, 1998); *see also* Treas. Reg. § 31.3121(v)(2)-1(b)(3)(iii).

provider does not automatically lose the right to make elections with regard to deferred compensation simply because the initial deferral was mandatory or presumptive.

IV. Special Considerations Relating to Mergers and Acquisitions, Corporate Restructurings and Reorganizations.

Proposal

The rigidity and complexity of Section 409A affects nearly all merger and acquisition, restructuring and reorganization activity. The following is a short summary of significant ways in which the statute affects M&A, restructuring and reorganization activities and of our recommendations as to future Treasury and Service guidelines with respect to such activity:

- The extent to which Section 409A permits or prohibits the traditional adjustment of equity compensation in connection with corporate transactions is currently unclear. We recommend that future guidance permit adjustments that do not significantly alter the economic terms of the options, even if those adjustments do not comport with the regulations regarding statutory options.

- Companies that do not want to inherit deferred compensation plans in connection with acquisitions are unable to terminate them and make distributions and must instead maintain them as frozen plans until Section 409A-compliant distributions can be made. We recommend that future guidance permit termination of deferred compensation plans and make immediate distributions in the acquisition context.

- Notice 2005-1 would appear to prohibit acquirors from giving holders of compensatory equity the right either to receive cash for their equity or to continue to roll over into corresponding equity of the acquiror, even in situations in which holders of non-compensatory equity are given that choice. We recommend that future guidance permit these elections.[49]

- In the case of stock options that are to be cashed out in a corporate transaction, there is a concern that the transaction documentation would convert the stock options into impermissible cash-settled SARs. We request that future guidance clarify that cash-out transactions are permissible in the context of a corporate transaction.[50]

- Employees who hold compensatory equity typically participate in escrows of transaction proceeds to pay indemnification claims and in earn-outs following a transaction. There is a concern that these arrangements may not be permitted by Section 409A. We request that future guidance clarify that these arrangements are permissible.

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[49] As a further point, Q&A 20(a) generally permits a termination of participation in a plan in 2005 if, among other things, the amounts subject to the termination are includible in the income of the participant in 2005 or, if later, in the taxable year in which the amounts are earned and vested. We request a clarification, in the context of options, SARs and similar instruments, that such a termination would permit an irrevocable election made in 2005 to exercise no later than the close of such taxable year, if the compensation would be included in the income of the participant in the taxable year in which the amounts are earned and vested (i.e., a clarification that the required exercise does not have to be at the specific point of vesting, but rather can be later in the same year).

[50] If cash settled SARs are permissible, then this clarification may be unnecessary unless the cash payment would constitute a modification of the award.

Our recommendations as to future guidance would continue to permit certain long-standing historical practices with respect to equity compensation and deferred compensation in the context of corporate transactions such as mergers and acquisitions, spinoffs, joint ventures, recapitalizations and reorganizations. If the regulations issued under Section 409A are not more narrowly tailored, these long-standing historical practices could be severely curtailed without advancing any legislative purpose of Congress in enacting Section 409A. We believe that none of the recommendations below present the potential for the abuse of deferred compensation or otherwise implicate the underlying policies of Section 409A in the transactional context.[51]

Discussion

A. Adjustment to Equity-Based Awards

We recommend that future guidance provide that options adjusted in connection with corporate transactions will not be subject to Section 409A if the adjustment complies with the Spread Test and the Ratio Test (generally applicable in respect of statutory options, as described below), there is no extension of the maximum term of the option and the options held by key employees are treated in the same manner as options held by others.[52] Other changes to an option, such as to recognize the new employment relationship in a spinoff, should not cause the option to become subject to Section 409A. We think that this test will capture all of the risk of abuse presented by the adjustment of options in corporate transactions but will continue to allow parties to corporate transactions to adopt appropriate, commercially reasonable adjustments to options in this context.

Notice 2005-1 raises questions about the extent to which Section 409A interferes with the traditional adjustment of stock options in corporate transactions. In typical mergers, options that are to be rolled over into acquiror stock options are adjusted by maintaining the aggregate exercise price and the aggregate spread of the options so that the holder is no better off, and no worse off, by reason of the transaction. In transactions such as spinoffs and joint ventures, practice is more varied; in spinoffs, for example, (i) it may be intended that employees hold options of the distributing company ("Distributing") and options of the distributed company ("Spinco") following the spinoff, (ii) it may be intended that Spinco employees hold only Spinco options and Distributing employees hold only Distributing options following the spinoff and (iii) options held by current Spinco and Distributing employees may be treated differently from options held by former employees. Traditionally, companies have had broad discretion to make these adjustments subject only to commercial, accounting and tax-deductibility concerns. In addition, the resolution of the treatment of options in these contexts will typically affect only the

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51 We specifically note that some of our proposals regarding the transactional context may be appropriate as a general matter, and we do not mean their inclusion in our discussion of transactions to imply that the relief is necessarily inappropriate where there is no corporate transaction.

52 The last sentence of Q&A 4(d)(ii) provides that "the requirement of §1.424-1(a)(5)(iii) will be deemed to be satisfied if the ratio of the option price to the fair market value of the shares subject to the option immediately after the substitution or assumption is *not greater than* the ratio of the option price to the fair market value of the shares subject to the option immediately before the substitution or assumption [emphasis added]." Read literally, this provision would give a company significant discretion to increase the spread of an option in connection with a corporate transaction. For example, if a company whose shares were valued at $20 per share declared a $5 cash dividend, this sentence would appear to permit the company to reduce the exercise price of an option with a $10 exercise price to *any* amount below $10 (for example, $1 per share), since the ratio of option price to fair market value immediately after the transaction ($1/$15, or 0.067) would always be "not greater than" the same ratio immediately before the transaction ($10/$20, or 0.5). Such an approach would be a significant departure from the principles of Q&A 4 generally that an option not have a feature providing for the deferral of compensation, and we question whether this departure is necessary.

companies involved in the transaction but generally will not adversely affect the tax treatment of the awards to the holders of the awards (and, in particular, would not subject the holders to penalty taxes and interest).

Notice 2005-1 arguably requires that the adjustment of stock options in connection with a corporate transaction comply with the adjustment provisions of Section 1.424-1 of the Treasury Regulations governing statutory options under Sections 422 and 423.[53] The Section 1.424-1 regulations, in turn, appear to require that an option that is adjusted in connection with a corporate transaction be re-tested immediately following the corporate transaction to see if the requirements applicable to the option have been met. The adjustment would avoid deferred compensation status only if the following requirements (among others) have been met:

- The adjusted option must have been granted by a corporation;
- The holder of the adjusted option must be a current employee of the corporation that issued the option, or of a "related corporation" (defined as a majority-owned subsidiary) or an employee who terminated within 90 days before the adjustment;
- The aggregate spread of the adjusted option immediately after the adjustment must be no greater than immediately before the adjustment (the "Spread Test");
- The ratio of the exercise price to the fair market value of the underlying shares immediately after the adjustment must be no greater than immediately before the adjustment (the "Ratio Test"); and
- The adjusted option must not contain new terms or give the holder any additional benefits that the holder did not have before the adjustment.

We understand that Notice 2005-1 requires compliance with the Section 1.424-1 regulations because of concern that companies may "hide" deferred compensation in the adjusted option (for example, by increasing the spread of the adjusted option to provide the holder with the opportunity to receive more value than immediately prior to the adjustment). Notwithstanding that, in our experience, this practice was very rare even before the enactment of Section 409A, we acknowledge that this concern is legitimate. Further, there was insufficient time to consider these issues in view of the pressing need for quick guidance.

We think that the concern can now be more tailored so as not to preclude a significant number of typical adjustments that present no real possibility of abuse. For example:

- The adjustment of an option or SAR in connection with a transaction involving entities other than corporations should be permitted.
- The adjustment of options or SARs held by former employees (including employees terminated in the 90 days prior to the adjustment) should be permitted.
- The addition of certain ancillary rights and benefits to an adjusted option, such as a cashless exercise feature, should be permitted.

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53 It is not clear whether Treasury intends that compliance with Section 1.424-1 be the exclusive means of avoiding the deemed grant of a new option, or whether other methods of compliance are permissible.

- In the context of a spinoff, joint venture or similar transaction, options and SARs should be able to be adjusted so that the holder continues to hold an option with respect to the entity that employed him or her following the transaction (or a majority-owned subsidiary).

The foregoing list is not exhaustive. We do not think that these examples present the risks of abuse contemplated by Section 409A. Further, because the options and SARs prior to adjustment will not typically have been deferred compensation (having been granted at the money), a requirement that they comply with the Section 1.424-1 regulations (or other Section 409A rules) presents a trap for the unwary that will frustrate the legitimate structuring and business goals of the participants in the market.

Fully importing into Section 409A the regulatory framework concerning modifications of statutory options does not appear to us to be necessary or advisable. The policy concerns underlying the provisions of the Code governing statutory options are very different from the policy concerns underlying Section 409A. Statutory options provide a number of tax benefits to the holders. The regulation of statutory options under the Code is largely technical and intended to ensure that the lost tax revenue serves the goal of employee ownership. Section 409A, however, was enacted to stop abuses by senior management with respect to their control over their deferred compensation. It does not serve the goal of preventing abuse by senior management to engraft these technical requirements onto Section 409A in the context of corporate transactions.

In addition, companies that grant options often grant them deeply into the ranks of the organization. Requiring that the adjustment of options comply with the Section 1.424-1 regulations, would expose, in many cases, a far greater number of individuals to the risk of penalty taxes and interest than merely senior management, whose actions Congress intended to reach in enacting Section 409A.

B. <u>Termination of Deferred Compensation Plans in Connection With Corporate Transactions</u>

Section 409A does not provide for the permitted distribution of deferred compensation upon termination of a deferred compensation plan. Distribution of deferred compensation upon plan termination was one of the abuses that motivated Congress to enact Section 409A. For example, it has been reported that Enron paid deferred compensation shortly before entering bankruptcy. Because deferred compensation is a general, unsecured obligation, Congress viewed distributions under these circumstances as a form of manipulation by senior management to provide themselves with greater rights than their employers' other general creditors (including, in some cases, rank and file employees).

However, Congress explicitly provided Treasury with the discretion to determine those situations in which acceleration of the payment of deferred compensation should be permitted, and we recommend that an exception be made for plans of a target terminated in connection with acquisition transactions. The legislative history to Section 409A reflects Congress's intent that accelerated distributions would be appropriate in situations beyond the control of the participant and so long as the distribution is not elective. In the context of an acquisition transaction, we believe that the risk of abuse is low because the termination of the plan will have been the subject of bona fide negotiations between the parties, and an independent check on management of the target will accordingly be present. In addition, the acquiror may have commercial reasons in wanting not to continue to sponsor the target's plans. For example:

- The acquiror may intend to terminate the target's tax-qualified defined benefit pension plan. If the acquiror could not terminate the target's supplemental retirement plan, then the acquiror would be in the awkward position of being unable to fully distribute all participants' vested benefits.

- An acquiror that does not itself sponsor deferred compensation plans may view the maintenance and administration of deferred compensation plans of its targets as commercially undesirable.

- The transaction may be a cash transaction, and the acquiror may intend to cash out equity awards that are deferred compensation, such as restricted stock units or stock appreciation rights.

- The target may be a partnership or entity other than a corporation and may not be permitted to rely on Section 409A(a)(2)(A)(v) and Q&As 11 through 14.

In each of these cases, we think that the abuse that led to the enactment of Section 409A would not be implicated. Indeed, if acceleration provisions were put into place by the target, many of these distributions would be permitted by Section 409A(a)(2)(A)(v) and Q&As 11 through 14. Congress's decision to permit distributions upon a change in ownership or control of a corporation reflects its assessment that the potential for abuse in this context is low.

We would note that the above relief should apply whether or not the transaction in question technically constitutes a Section 409A(a)(2)(A)(v) event, and whether or not the plan in question already provides for acceleration upon the occurrence of the transaction. Rather, the emphasis should be on whether the transaction is a bona fide corporate (or similar) transaction not motivated by compensatory concerns, and whether the plan termination is consistent with the transaction (e.g., whether the terminated plan is a plan of the acquired entity). For purposes of identifying which entity is being acquired (and, therefore, whose plans may be terminated), we suggest the application of rules similar to the ones applicable for purposes of Section 280G to identify the entity that undergoes the change in control (so that, among other things, as provided for purposes of the Section 280G regulations, there will be circumstances in which only one entity would be deemed to have been acquired).

C. <u>Elective Rollover of Equity Compensation Awards</u>

Prior to the enactment of Section 409A, it was often the case in corporate transactions that employees would be provided with a choice of whether to receive cash for their equity awards in connection with the transaction or have these awards converted into new arrangements with the acquiror. These equity awards might be deferred compensation within the meaning of Section 409A (for example, restricted stock units) or might not be deferred compensation within the meaning of Section 409A (for example, stock options that were at the money when granted and otherwise complied with Notice 2005-1). Examples of these situations include the following:

- Company A will acquire Company T and will, at the election of a T shareholder, either pay $X per share of T common stock or will deliver one share of A common stock. A and T intend that A will offer the same consideration to holders of A options and restricted stock units at the election of the holders of the awards.

- Management of Company T are planning to acquire Company T in a leveraged buyout. The equity sponsor of the leveraged buyout insists that T management agree to the cancellation of their outstanding stock options (which are not deferred compensation) and, in consideration of the cancellation of these awards, will receive restricted common stock of T. Other employees of T would receive cash for their equity awards at the consummation of the transaction.

Section 409A generally should not apply in a corporate transaction in which (i) equity awards are not deferred compensation, (ii) all holders of those equity awards are given the same election and (iii) the elections given to the holders of those equity awards are substantially the same as the elections given to the shareholders; and we recommend that future guidance provide that the offering and making of such an election is not subject to Section 409A. The presence of a bona fide, arm's-length corporate transaction and the substantial identity of treatment of the holders of compensatory and non-compensatory equity we feel effectively eliminate any risk of abuse of the kind that Section 409A was intended to prevent. *We believe that Section 409A should likewise not apply if both the pre-transaction and post-transaction arrangements are not deferred compensation, even if the conditions in the foregoing clauses (ii) and (iii) are not met.* (Pre-Section 409A principles of constructive receipt, as well as Section 83 and the Section 83 regulations, would continue to apply.)

In the situation in which the equity awards are deferred compensation but the conditions of clauses (ii) and (iii) of the first sentence of the previous paragraph are met, future guidance should permit a cash payment pursuant to such an election as a permitted acceleration under Section 409A(a)(3) and Q&A 15. Because all holders are given the same election, and because that election is the same as the election given to shareholders generally, permitting these elections under Section 409A merely and reasonably permits all similarly situated individuals to be treated in a similar fashion. *Future guidance should also confirm that the rollover with respect to an employee who elects not to receive cash is a continuation of the existing deferral, and not a further deferral subject to Section 409A(a)(4)(C).* The rollover merely prevents the transaction from disrupting the equity award arrangements. It is not a deferral chosen by the service provider but rather merely an arrangement designed to prevent events beyond the provider's control (i.e., transactions) from disrupting existing arrangements.

D. <u>Other Recommendations</u>

The following are additional recommendations for future guidance. We believe that all of these recommendations are consistent with Section 409A and with Notice 2005-1. Nevertheless, because of the potential risk of incurring the excise taxes and interest under Section 409A, we think that the arrangements noted below should be approved explicitly.

1. <u>Cash-Out of Stock Options</u>

As noted above, most stock options will not constitute deferred compensation because they are granted at or out of the money. Some practitioners are concerned that, if parties to a corporate transaction agree that the options will be cashed out upon consummation of the transaction, the options at that moment are converted into cash-settled stock appreciation rights (i.e., the right to receive cash at the consummation of the transaction), which Notice 2005-1 prohibits. We believe that the better view is that the cash-out of options in a corporate transaction constitutes the disposition of the options pursuant to 1.83-7(a) of the Section 83 regulations. We recommend that future guidance confirm that the cancellation for cash of stock options that do not constitute deferred compensation in a corporate transaction is not an event to which Section 409A applies. In our view, because the parties to the underlying transaction have agreed on the price to be paid on the underlying common stock, it is not appropriate to consider the cash-out right to be a stock appreciation right in the traditional sense, as opportunity for further appreciation of the in-the-money value of the option will usually be de minimis. In addition, the right to receive cash is incidental to the corporate transaction and has no separate compensatory purpose.

2. <u>Earn-outs and Escrows Relating to Indemnification</u>

In many corporate transactions, the parties to the transaction agree that a portion of the transaction proceeds will be withheld and used, if necessary, to satisfy indemnification claims. If not needed to satisfy indemnification claims, the proceeds are released to the sellers at the end of a fixed period. In other corporate transactions, a portion of the sale proceeds may be contingent on meeting future performance goals (for example, certain earnings thresholds or government approval of a significant new product). Holders of compensatory equity (which may or may not be deferred compensation) are typically required, as a condition to the transaction, to participate in these arrangements so as to avoid providing the compensatory equity holders with different consideration than is provided to the underlying shareholders.

Q&A 10 provides that an amount of deferred compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on (among other things) the occurrence of a condition that is related to the purpose of the compensation, so long as the possibility of forfeiture is substantial. We think that Treasury and the Service should confirm that these indemnification and earn-out arrangements result in a substantial risk of forfeiture, such that payment of amounts pursuant to these arrangements shortly after the dates specified in the transaction agreement would be short-term deferrals within the meaning of Q&A 4(c).

V. Payments Relating to Employment Termination.

A. Severance Benefits

Severance benefits raise the most basic of questions under Section 409A, including whether severance benefits should be treated as nonqualified deferred compensation for purposes of Section 409A, and, if so, whether there should be any exceptions. Neither Section 409A nor the relevant legislative history offer much, if any, insight on these questions.

Proposal

- Severance should be recognized as a special form of payment that is not conducive to the regulatory framework contemplated by Section 409A regarding time and form of elections.

- Severance should be defined as payments or benefits offered to a service provider which (i) are not in the nature of previously deferred compensation or retirement benefits, and (ii) are provided in connection with a termination of the provider's services; but only if and to the extent payments were not required to be provided to the service recipient on any termination or on any termination without cause (i.e., a payment will not be treated as severance to the extent the service recipient was generally required to make the payment upon termination, even if no payment is required upon termination for cause).

- For any service provider who is not a key employee at the time of termination, severance should not be treated as subject to any part of Section 409A.

- For any service provider who is a key employee, severance should not be subject to Section 409A, except Section 409A(a)(2)(B)(i), subject to the exception set forth in the last bullet-point in this list, below.

- If the severance benefit is provided pursuant to an arrangement adopted, entered into or materially modified as to the amount, timing or conditions of payment within the 12-month period immediately prior to the date of termination of service (i) its payment will be subject to Section 409A(a)(2)(B)(i) (with the exception provided in the last bullet-point in this list, below) and (ii) it will be subject to all of the provisions of Section 409A unless it can be established by clear and convincing evidence that the severance benefit is not provided in forbearance of any other obligation of the service provider to the service recipient which was in the nature of deferred compensation.

- Even if a person is a key employee receiving severance benefits otherwise subject to Section 409A, any cash severance payments made within the six-month period after termination of service will not violate Section 409A if the aggregate of such payments made during such six-month period generally does not exceed 50% of the key employee's historical average annual salary and bonus reported on his W-2 for the preceding five taxable years (or lesser period of employment), adjusted to exclude certain extraordinary payments.

Discussion

Severance benefits generally consist of payments and benefits made available to a service provider in connection with the untimely termination of the service provider's services. The benefits are intended to compensate the service provider for the career damage caused by an untimely termination and to help the service provider maintain economic security until the service provider can adjust to the change or arrange an alternate source of support. Payments may also be conditioned on the employee abiding by a non-compete agreement and other post-employment obligations lasting through the severance payment period.

In most cases, it would be difficult to identify the point at which a severance benefit entitlement could be said to be "earned and vested" or constitute a "legally binding right." Severance arrangements generally take one of the following forms:

- Broad-based severance plans and policies, which, by their terms, often can be modified or terminated by a service recipient at any time – A service provider might not have a legally binding right to a severance benefit under this type of arrangement until the benefit is actually provided in connection with a qualifying termination of the service provider's employment.

- Plans and agreements that by their terms cannot be modified or terminated, at least not during a designated protected period (e.g., a severance plan that provides fixed severance protections during a period of time after a threatened or actual change in control of a service recipient) – It is not clear whether a service provider's benefit under such a plan becomes a legally binding right on the date the protection is triggered or only when the service provider's services are terminated during the protected period.

- An individual employment or severance protection agreement which provides contractual severance benefits payable if a service provider experiences a qualifying termination during a stated term – These arrangements generally provide benefits upon an actual or constructive termination of the service provider's services by the service recipient without cause. However, it is not uncommon for parties to agree to treat a termination as a voluntary resignation, which would generally not trigger severance benefits under a severance agreement. Nevertheless, the parties often enter into a settlement agreement under which the service provider agrees to release all claims against the service recipient in return for severance benefits which often mirror (but can be greater or lower than) the benefits that would have been provided under the agreement if the termination had been treated as a constructive termination by the service recipient without cause.

- Negotiated severance benefits in the absence of a pre-existing plan or agreement – Even where there exists no formal severance agreement or severance plan, it is not uncommon for a service recipient to pay severance benefits to terminated service providers on an ad hoc basis, often in exchange for a release of claims by the service provider.

Many broad-based severance plans are designed to pay participant severance benefits within a period of 24 months following a participant's termination in order to avoid the severance benefit arrangement's being treated as a deferred compensation or pension benefit plan subject to the vesting and other substantive rules applicable to pension benefits under ERISA. The Department of Labor's regulations under ERISA state that severance benefit arrangements will not be subject to the pension plan rules if (i) the payments are not contingent, directly or indirectly, on the participant's retirement, (ii) the total payments do not exceed twice the participant's annual compensation, and (iii) the payments are generally completed within two years after termination of the participant's employment.[54]

From a Section 409A perspective, if a severance arrangement were to be included within the definition of nonqualified deferred compensation, the principal effects would be:

- A service provider covered by the arrangement would be required to elect the form and timing of payment of the severance benefit (e.g., lump sum or installments) prior to the date on which the service provider had acquired a legally binding right to receive the benefits. Rules would be needed to determine the point at which a service provider acquired a legally binding right to receive severance benefits in various scenarios.

- Once the form and timing of the payment of severance benefits had been determined and a legally binding right to the benefits was deemed to exist, any subsequent change to the form and timing would be subject to the limitations and conditions under Section 409A(a)(4)(C) (i.e., changes would have to be made at least 12 months prior to the first severance payment and would have to defer receipt of benefit payments for at least five years).

- Key employees would be prohibited from receiving any severance benefits until at least six months after a termination of their services.

If severance arrangements were exempted from all of the provisions of Section 409A, this result might give rise to two types of abuses that would be contrary to the spirit and purpose of Section 409A. First, certain deferred compensation arrangements might be crafted as severance, avoiding the deferral and payment election timing rules of Section 409A. For example, with implicit consent of a service provider, a service recipient could determine that in lieu of paying a large bonus in a current tax year, the service provider would be given a severance promise payable upon the termination of the service relationship. If this severance promise were not subject to Section 409A it would avoid the conditions and limitations of Section 409A. Presumably, a service provider and service recipient would only strike this type of implicit bargain if the amounts payable as severance were certain to be paid regardless of the circumstances of the termination of the service provider's services. An arrangement that conditions payment based on the circumstances of termination or allows the service recipient to unilaterally reduce or eliminate the promised severance would not provide an assurance of payment indicative of abuse under Section 409A. Stated differently, an arrangement that conditions payment on the circumstances of termination or allows the service recipient to unilaterally reduce or eliminate the promised severance would not provide a level of assurance of payment that is the hallmark of nonqualified deferred compensation and would presumably not be a concern to the Treasury or the Service under Section 409A.

[54] 29 C.F.R. § 2510.3-2(b).

However, an arrangement that makes severance payable regardless of the circumstances of a termination of the service provider's services (or under any circumstances other than a termination for "cause") and does not allow the service recipient to unilaterally reduce or eliminate the promised severance might properly be viewed as disguised nonqualified deferred compensation.

Second, if severance were broadly exempted from Section 409A, key employees of a troubled service recipient might negotiate for themselves impromptu exit packages crafted as severance and receive the severance payments without observing the six-month waiting rule that would otherwise apply to nonqualified deferred compensation under Section 409A. Key employees could, in fact, negotiate the severance benefits as a putative replacement for payments of previous deferred compensation which the key employees would otherwise not be able to receive for at least six months following their departure. Anticipating that the service recipient might be insolvent in six months, key employees could negotiate the severance payments as a proxy for the deferred compensation they stood to lose.

Perhaps recognizing these concerns, Notice 2005-1 provides temporary relief for certain severance arrangements which do not cover key employees, but offers no exception for severance arrangements covering key employees. Q&A 19(d) states that severance benefits under a plan that is either (i) a collectively bargained plan or (ii) covers no service providers who are key employees, are not required to meet the requirements of Section 409A during the calendar year 2005.

The term "key employee" includes officers (subject to a cap of 50) who earn $135,000 or more. While Section 409A imposes a distinction between key employees and non-key employees for purposes of amounts which clearly constitute nonqualified deferred compensation, this distinction would have a more arbitrary affect if it were to apply with respect to severance. If all severance payable to a key employee were treated as nonqualified deferred compensation and subject to the standard six-month waiting period under Section 409A, then all key employees would potentially be subject to six full months of unemployment before they could receive severance payments. It is not clear to us that this was the intent of Section 409A.

Although severance arrangements may present a limited opportunity for abuse by high-level employees, subjecting all severance arrangements that cover key employees to Section 409A is, we think, an unnecessarily broad reaction. We support all efforts to find an appropriate compromise. We believe that relying on the short-term deferral exception under Q&A 4(c) to exempt all severance payments made within 2-1/2 months after the end of the service provider's tax year in which the associated termination of service occurred may lead to unintended results. First, it encourages taxpayers to fashion severance arrangements that pay out immediately on a termination of employment which seems contrary to one of the primary purposes of Section 409A – to avoid key employees rushing to take distributions when exiting a potentially insolvent company. Second, exempting some severance payments (i.e., those made within the 2-1/2 month period) would result in an uninterrupted flow of payments for anyone terminating before October of a calendar year. On the other hand, imposing the requirements of Section 409A on all key employee severance which pays out over a period exceeding the time frame of the short-term deferral exception seems unnecessarily restrictive in light of the nature and purpose of most bona fide severance arrangements. Severance is often paid in a stream of installments over an extended period of time for a variety of reasons (e.g., because it is intended as salary replacement or because the service provider has agreed to restrictive covenants (non-compete, non-solicit, non-disparagement) the observance of which is promoted by installment payment of severance).

Finally, we believe that the danger that a key employee of a troubled company might negotiate an impromptu severance benefit as a proxy for previously deferred compensation in order to receive the severance benefit without observing the six-month waiting rule is probably only a concern for severance benefits negotiated within 12 months of the key employee's departure. An abuse of this sort is likely to be perpetrated, if at all, only when the company's insolvency and a key employee's departure are imminent. Thus, a rule that addresses severance arrangements that are adopted or amended within 12 months of a key employee's departure should be sufficient to avoid this type of abuse.

Based on the foregoing, we recommend that the guidance provide what we believe is a simple but adequately protective approach to severance, as follows.

- The guidance should define severance as payments or benefits made to a service provider which are not in the nature of previously deferred compensation or retirement benefits and are provided in connection with a termination of the service provider's services; but only if and to the extent payments were not required to be provided to the service recipient on any termination or on any termination without cause. For these purposes, severance benefits would not be deemed to be required to be provided if the benefits were subject to reduction or elimination either at the discretion of the service recipient or based upon events or conditions arising after the severance benefit right is established, unless the exercise of this discretion or the occurrence of the events or conditions are unlikely. The mere condition that the key employee execute a standard waiver and release in favor of the service recipient in order to receive a promised benefit should typically not disqualify the payment from being characterized as severance for this purpose.

- For any service provider who is not a key employee (determined as described below) the guidance should provide that severance benefits provided to such service provider will not be treated as nonqualified deferred compensation subject to Section 409A. Employees who are below the most senior ranks, and certainly those below the level of key employee, generally will not have the leverage nor the inclination to fashion an implicit bargain with a service provider to disguise nonqualified deferred compensation as severance. This type of leverage and access would presumably be available, if at all, only to the most senior employees of a service recipient. Accordingly, we believe that severance payable to non-key employees can safely be excluded from Section 409A. Where a plan or arrangement covers both key employee and non-key employees, it should be considered two separate plans for purposes of Section 409A – one covering each group.

- For any service provider who is a key employee, the guidance should provide that amounts payable as severance to such a service provider will not be subject to the full array of Section 409A but will be required to meet the six-month rule of Section 409A(a)(2)(b)(i).

- Severance benefits provided to a key employee will be presumed to constitute nonqualified deferred compensation under Section 409A if the benefits are provided under a severance arrangement adopted, entered into or materially modified as to the amount, timing or conditions of payment within the 12-month period immediately preceding a termination of the service provider's services which triggers the payment of the severance benefits. This presumption could be rebutted by clear and convincing evidence the new or modified benefit is not provided in forbearance of any other obligation of the service provider to the service recipient which was in the nature of deferred compensation. We envision the application of a standard here similar to the standard developed under Section 280G regarding parachute payments. If the presumption is not rebutted, the date on which the arrangement providing for such benefits is deemed to be a legally binding arrangement would be the first date occurring within the 12-month period immediately preceding the severance triggering date on which the severance arrangement is initially adopted or entered into or is materially modified, in each case in a legally binding manner. Accordingly, as described above, as of this date the arrangement must include a distribution election complying with the requirements of Section 409A(a)(2), and any change in this initial distribution election after the date on which the arrangement is deemed to be a legally binding arrangement will be subject to the change in time and form rules of Section 409A(a)(4)(C). As also described above, however, the Section 409A(a)(4)(C) rules regarding the change in time and form of distribution need not be recited in the arrangement, as long as any change in time and form of distribution complies with the substance of the Section 409A(a)(4)(C) provisions.

- To the extent that severance payments to a key employee are subject to the rule under Section 409A(a)(2)(B) prohibiting distributions of nonqualified deferred compensation amounts to a key employee within six months after the key employee's employment, there would be no violation of that rule to the extent that the amounts distributed to the key employee during such period do not exceed 50% of the key employee's historical average annual compensation (using for purposes of this calculation the principles applied to determine an employee's "base amount" under Section 280G, but excluding items of extraordinary compensation such as income from the exercise of stock options).[55]

B. <u>Six-Month Rule Applicable to Distributions to Specified Employees Upon a Separation From Service</u>

1. <u>Determination of "Specified Employees"</u>

<u>Proposal</u>

We concur in the recommendation made by other commentators that the guidance make clear that the "key employees" of covered corporations should be determined in accordance with Section 1.416-1 of the Treasury Regulations. We also concur in the recommendations made by others that the guidance permit a corporation to determine its key employees as of December 31 of each year and have that determination apply for the 12-month period beginning as of the next April 1; provided, however, that any individual who is an executive officer (within the meaning of Rule 16a-1(f) of the Securities and Exchange Commission under the Securities Exchange Act of 1934 (or would be if such Act applied)), at the time of separation from service, should also be considered a key employee. This approach will give corporations time to perform the key employee analysis to determine the key employee group and avoid uncertainties in the interim period while the analysis is being performed.[56]

<u>Discussion</u>

Section 409A(a)(2)(B) provides that if a service provider intends to satisfy the distribution timing requirements of Section 409A by providing that a distribution shall be made upon a "separation from service" (as permitted under Section 409A(a)(2)(A)(i)) and the service provider is a "specified employee," the separation from service requirement will be met only if the distributions may not be made before the date which is six months after the date of separation from service. A "specified employee" is a

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[55] 50% is generally consistent with the amount of payments that could be made under the Department of Labor's guidelines relating to severance. *See* footnote 54 above and accompanying text.

[56] We make this recommendation expecting that there would be a single, uniform definition of "specified employee" for all Section 409A purposes.

key employee (as defined in Section 416(i), without regard to paragraph (5) thereof) of a corporation any stock in which is publicly traded on an established securities market or otherwise. This six-month restriction is intended to limit the ability of key employees to put themselves ahead of other unsecured creditors of a company by departing the company a short period of time before the company becomes insolvent.

Under Section 416(i) an employer's key employee group will include (i) up to 50 officers of the employer having annual compensation greater than $130,000 (currently $135,000, as a result of applicable "COLA" adjustment); (ii) a 5% owner of the employer; and (iii) a 1% owner of the employer having annual compensation greater than $150,000.

The Treasury Regulations under Section 1.416-1 provide guidance on determining "compensation," identifying "officers" and calculating 5% and 1% owners. These regulations need to be modified to reflect amendments to Section 416(i) under the Economic Growth and Tax Relief Reconciliation Act of 2001, but, to the extent that the modifications are consistent with Section 416(i) and the current approach taken under the regulation, we believe that it would be appropriate and helpful for the Treasury to make clear that the regulations under Section 416 apply equally for purposes of determining the relevant key employees under Sections 416(i) and 409A(a)(2)(B).

The determination of a corporation's key employee group under Section 416 is necessary only if the corporation might be required to make contributions to a qualified plan which is deemed to be top-heavy under Section 416. Many corporations do not have to perform a Section 416 analysis because their qualified plans are in no danger of being top-heavy. Even corporations that do perform a top-heavy analysis may not identify their key employee group until well after a plan year has ended. Employers are generally permitted under existing Section 1.416-1, Q&A T-21, of the Treasury Regulations to use calendar year compensation for making key employee determinations.

Based on the foregoing we recommend that the guidance permit a corporation to determine its key employees as of December 31 of each year and have that determination apply for the 12-month period beginning as of the next April 1 except that any executive officer within the meaning of the Securities Exchange Act of 1934 would be considered a key employee at all times.

<u>Guidance Needed to Identify "Specified Employees"</u>

The following general questions should be answered to enable correct identification of "specified employees":

1) Do the same aggregation/non-aggregation rules that apply under Section 416(i) apply for purposes of Section 409A? For example, is 1% or 5% ownership to be determined without controlled group aggregation as under Section 416?

2) Does an employer have the same options in determining Section 415(c)(3) compensation for purposes of identifying "specified employees" as it has in determining Section 415(c)(3) compensation under its qualified plans? (For example, may it choose between the safe harbor and an alternative definition?) If so, must it use the same methodology it applies under its qualified plans?

3) Must an individual be a common law employee of a member of the payor's controlled group in order to be a "specified employee"? If not, how will the rules governing partners in partnerships under the Section 416 regulations be applied

in this context, given the requirement that he or she be an employee of a "public company"? This is not a relevant concept under Section 416(i).

2. Determination of "Public Company"

Proposal

We recommend that the same rules used under Section 280G apply for determining whether the stock of a corporation is "publicly traded on a recognized securities exchange or otherwise" for purposes of Section 409A(a)(2)(B).

Discussion

Section 280G provides that the golden parachute excise tax provisions thereunder will apply to a corporation unless no stock of the corporation is "readily tradable on an established Securities market or otherwise." Section 1.280G-1, Q&A 6, of the Treasury Regulations defines "established securities market" by reference to Section 1.897-1(m) of the Treasury Regulations, which interprets this term to include (i) a national securities exchange registered under Section 6 of the Exchange Act, (ii) a foreign national securities exchange officially recognized, sanctioned or supervised by a governmental authority, and (iii) any over-the-counter market which uses an interdealer quotation system. A very similar definition is used under a variety of provisions of the Code and the Treasury Regulations which relate to issuers and securities which are readily tradable on established securities markets or otherwise.[57]

VI. Application of Section 409A to Hedge Funds and Other Investment Funds.

Proposal

Section 409A raises potentially difficult issues in the context of a number of ordinary compensation arrangements involving investment managers. In a typical arrangement, the manager will have a contractual arrangement with the fund providing for the payment of a management fee (e.g., 2% of assets under management) and an annual incentive fee (e.g., 20% of the annual increase in the fair market value of the fund's assets). Many fund managers offer their employees and equity holders the opportunity to defer a portion of their compensation.

As discussed below, we propose that:

- The rules expressly permit back-to-back elections without unintended adverse consequences under Section 409A, if the individual's election satisfied Section 409A.
- There be a clarification that managers receiving incentive fees with respect to mid-year redemption by investors may rely on the six-month deferral timing rule with respect to the portion of the incentive fee payable at the end of a regular 12-month performance cycle.
- There be a clarification that the mere existence of a foreign obligor should not trigger the adverse provisions in Section 409A applicable to certain offshore trusts used to fund deferred compensation.

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57 S*ee, e.g.*, § 453; Treas. Reg. § 15A.453-1(e)(4)(iv); § 7704; Treas. Reg. § 1.7704-1(b); § 1092; Treas. Reg. § 1.1092(d)-1(b)(1)).

Discussion

A. “Back-to-Back” Arrangements – In General

As noted above, many fund managers offer their employees and equity holders the opportunity to defer a portion of their compensation. Employees and equity holders execute deferral agreements which defer the compensation to the earlier of a stated number of years or termination of employment. Pursuant to the terms of an investment management agreement between the fund and the manager, the manager may elect to defer all or a portion of the management fee or incentive fee, and, generally, the manager would make a deferral election in respect of its fees for the fund that corresponds to the individual’s election. If the manager elects to defer all or a portion of the fees, the applicable fee is never paid from the fund and the assets remain in the fund, indexed to the future investment returns of the fund for the period of the deferral. The deferred assets are not segregated from the other assets of the fund and are fully available to satisfy all creditors of the fund. Investors generally like to see managers enter into deferral arrangements because the assets remain invested pari pasu with such investors and the arrangement aligns the interests of the manager with those of its investors. Generally, the only income that managers receive is management and incentive fees payable from the fund, and there is no other source of income to satisfy the payment obligation which would arise if an employee or equity holder deferral is accelerated as a result of a termination of employment.

A deferral election by a manager will generally mirror the deferral election made by employees and equity holders and permit a distribution to the manager upon the employee or equity holder ceasing to provide services to the manager. For administrative purposes, the deferral elections of some managers are often broken out into subaccounts reflecting the interests of each employee and equity holder which makes a deferral with the manager. If the electing individual terminates his service with the manager for any reason prior to the deferral date specified by the manager (with respect to its deferral) the deferred compensation attributable to the terminated individual will be paid by the fund to the manager and distributed to the individual. Such an early distribution does not affect the deferral attributable to the remaining employees or manager.

However, Section 409A(a)(2) permits distributions not earlier than (i) separation from service as determined by the Secretary; (ii) the date the participant becomes disabled (as defined), (iii) death, (iv) a specified time, (v) a change in ownership or effective control or (vi) the occurrence of an unforeseeable emergency. Technically, a question arises as to whether the manager’s back-to-back election satisfies this rule if it refers to a termination of employment by the manager’s service provider. Q&A 8, which provides generally that Section 409A applies only to individuals, would adequately address this technical point, except that there is an exception in Q&A 8 for personal service corporations (and similar entities) and there is a question in the case of a number of managers whether they would be (or be similar to) personal service corporations. Thus, we suggest that Treasury and the Service clarify that the mere presence of a back-to-back arrangement to facilitate an otherwise permissible election by an individual does not result in a failure to satisfy Section 409A. Alternatively, we would seek a clarification that the service provider’s termination of service from the manager should qualify as an applicable “separation of service” for purposes of whether deferred compensation becomes payable. Another approach would be to liberalize Q&A 8 so as to effectuate more clearly the result that Section 409A only applies to individual service providers. We submit that any contrary result is unintended and unwarranted and would result in an inability of managers to be able to provide otherwise properly structured deferred compensation to its employees for no apparent policy reason and without any abuse.

B. Performance-Based Compensation and Timing of Deferral Elections

Generally, the timing of most managers' deferral elections with respect to management fees and incentive fees conform to the requirements of Section 409A (i.e., they are made no later than the close of the taxable year that precedes the taxable year in which the services giving rise to the fees are rendered). Section 409A, however, expressly provides a more favorable rule with respect to "performance-based compensation." Section 409A permits a service provider to elect deferral no later than 6 months before the end of the performance period. For purposes of this special rule, Section 409A(a)(4)(b)(iii) requires that the performance-based compensation to be based on services performed over a period of at least 12 months.

Incentive fees payable to managers by funds are generally based on the performance of such manager over a 12-month fiscal year and thus appear to be subject to the more favorable six-month rule. However, many managers are entitled to receive a prorated incentive fee at the time an investor redeems his interest in the fund (even if the investor is redeeming in the middle of the performance period). Even if these pro rata incentive fees are not being deferred, the mere ability to receive a pro rata incentive fee during the fiscal year could cause the fee to be considered not based on a performance period of at least 12 months. We request clarification that managers receiving incentive fees with respect to mid-year redemptions may rely on the more favorable six-month deferral timing rule with respect to the portion of the incentive fee payable at the end of the regular 12-month performance cycle.

C. Trust and Other Arrangements

Section 409A(b) provides that deferred amounts that are transferred or located outside of the United States and are set aside (directly or indirectly) in a trust (or other arrangement determined by the Secretary) for purposes of paying deferred compensation would be subject to immediate taxation. The provision does not apply to assets located outside the United States if substantially all of the services to which the deferred compensation relates are performed in the jurisdiction where the assets are held. A number of U.S. fund managers are known to provide their investment management services to offshore funds from offices within the United States. Accordingly, this special exception would not appear to be available.

Based on the legislative history to Section 409A, it appears that Section 409A(b) was intended to apply specifically to "offshore rabbi trusts" and similar arrangements when a service recipient "sets aside" or segregates a portion of its assets pursuant to a specific arrangement for the benefit of the service provider. Offshore funds could be found to be "arrangements" located outside of the United States, which have may have an obligation to pay deferred compensation. Thus, we submit that the rules should be clarified to the effect that no "arrangement" should be deemed to exist in violation of Section 409A(b), in the situation when deferred compensation is payable by a foreign obligor (regardless of the obligor's legal form) which is also the recipient of the services for which the deferred compensation is payable, unless the foreign obligor takes an action that amounts to a "segregating" of the deferred compensation assets. Essentially, an arrangement should be captured by these rules if an applicable off-shore funding arrangement is established by a service recipient, not merely because the service recipient itself (or an operating affiliate, as applicable) is a non-US entity. In this way, the reach of Section 409A will be appropriately limited to the types of arrangements sought to be addressed by the rules, rather than extending to entities merely by virtue of their business structure.