

IRC §409A for the Corporate Lawyer

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INTRODUCTION

The law of nonqualified deferred compensation, *i.e.*, compensation deferred by means other than qualified retirement plans described in [IRC §401](#) (or other tax-deferred plans, annuities, or accounts), has historically been defined by two doctrines.

Under the constructive receipt doctrine, an item of income is considered received by a taxpayer and so is includable in gross income under [IRC §451\(a\)](#) in the year it is “made available so that [the taxpayer] may draw upon it at any time” as long as “its receipt is [not] subject to substantial limitations or restrictions.” [Treas Reg §1.451-2\(a\)](#).

Under the economic benefit doctrine, a taxpayer receives a taxable economic benefit in the year cash or other property is transferred by the taxpayer’s employer to the taxpayer or to a trust for the taxpayer’s benefit, provided the taxpayer’s interest in the property or trust is not subject to a substantial risk of forfeiture and, in the case of a transfer in trust, the trust is not subject to the employer’s general creditors. [Sproull v Commissioner \(6th Cir 1952\) 194 F2d 541](#).

As codified in [IRC §83](#), the economic benefit doctrine applies to property transferred in connection with the performance of services to anyone other than the person for whom the services are performed. There is an exception for shares of stock acquired on the exercise of incentive stock options qualified under [IRC §422](#) or under employee stock purchase plans qualified under [IRC §423](#), but the spread between the fair market value of the shares acquired on the exercise of incentive stock options and the exercise price on the date of exercise is sub-

ject to alternative minimum tax under [IRC §56\(b\)\(3\)](#).

These doctrines often allow employees or independent contractors (“service providers”) to avoid immediate taxation of compensation that they are legally entitled to receive at a later date. Because of the time value of money, deferral of compensation is a big tax advantage to a service provider. This tax advantage is theoretically matched by the tax disadvantage suffered by the employer or service recipient in having to defer a deduction for the compensation until it is included in the income of the service provider. [IRC §404\(a\)\(5\)](#). But if the service recipient is operating at a loss, as is often the case with start-up companies, or is otherwise able to shelter its income, as is often true of corporate employers that are not subject to the passive loss rules of [IRC §469](#), which limit the use of individual tax shelters, this disadvantage is more apparent than real.

IMPACT OF §409A

Internal Revenue Code §409A, added by the American Jobs Creation Act of 2004 (Pub L 108-357, 118 Stat 1634), tightens the requirements for nonqualified deferred compensation for amounts deferred after December 31, 2004. On December 29, 2004, the IRS issued interim guidance in [Notice 2005-1, 2005-1 Cum Bull 274](#), and on October 4, 2005, the IRS issued proposed regulations (corrected December 16, 2005) regarding the application of [IRC §409A](#) to nonqualified deferred compensation plans in [REG-158080-04, 2005-2 Cum Bull 786](#). Final regulations were published on April 17, 2007.

TD 9321, 2007–19 Int Rev Bull 1123; Treas Reg §1.409A–1–1.409A–6.

Section 409A does not prevent deferred compensation that is includable in income under the constructive receipt or economic benefit doctrine from being included in income earlier than is required by the statute.

Under IRC §409A(a)(1)(A), if in any year a plan fails to satisfy or is not operated in accordance with §409A's requirements for nonqualified deferred compensation, all compensation of a service provider deferred under the plan is includable in gross income to the extent that it is not subject to a substantial risk of forfeiture and has not previously been included in gross income. Section 409A(a)(1)(B) adds, to the tax on the amount a service provider is required to include in income for failure of a plan to satisfy these requirements, an additional tax equal to 20 percent of the included compensation and interest at the IRC §6601 underpayment rate plus 1 percentage point on the income tax that would have been incurred had the compensation been includable in the year in which it was first deferred or, if later, in the first taxable year in which it was not subject to a substantial risk of forfeiture.

Section 409A does not prevent deferred compensation that is includable in income under the constructive receipt or economic benefit doctrine from being included in income earlier than is required by the statute. It prescribes requirements that compensation not otherwise subject to inclusion under the constructive receipt or economic benefit doctrine must satisfy to avoid being included in income currently.

DEFERRAL REQUIREMENTS OF SECTION 409A

Section 409A(a)(2), (3), and (4) prescribe requirements for distributions of deferred compensation, acceleration of deferred compensation, and elections to defer compensation, respectively, under a nonqualified deferred compensation plan. To satisfy IRC §409A(a)(2), (3), and (4), the material terms of the plan must be set forth in writing. Treas Reg §1.409A–1(c)(3)(i).

Election to Defer Compensation

Under IRC §409A(a)(4)(B)(i), a service provider's election to defer compensation earned in a taxable year must, in general, be made not later than the close of the preceding taxable year of the service provider. Treas Reg §1.409A–2(a)(3). An election to defer compensation for purposes of IRC §409A(a)(4)(B) includes an election as to the time and form (but not medium) of payment. Treas Reg §1.409A–2(a)(1). Payment in a lump sum, installments, or a life annuity are treated as different forms of payment. Treas Reg §1.409A–2(b). In the first year the employee or service provider becomes eligible to participate in a plan of deferred compensation, the election may be made within 30 days of the date the service provider becomes eligible to participate. IRC §409A(a)(4)(B)(ii); Treas Reg §1.409A–2(a)(7). Thus, if an existing employee wants to defer future compensation, the employee must as a general rule make an election to do so before January 1 of the year in which the compensation is earned. A new employee has 30 days after starting work to make an election to defer compensation.

In the case of a legally binding right to compensation subject to a forfeiture condition requiring a service provider's continued service for at least 12 months, the election may be made within 30 days of the date the service provider obtains the legally binding right to the compensation, provided that the election is made at least 12 months before the earliest date on which the forfeiture condition could lapse. Treas Reg §1.409A–2(a)(5). In the case of an employer or service recipient with a fiscal year other than the calendar year, an election to defer compensation earned within its fiscal year may be made before the end of its preceding fiscal year. Treas Reg §1.409A–2(a)(6). In the case of performance-based compensation based on services performed over a period of at least 12 months, the election may be made no later than 6 months before the end of the period. IRC §409A(a)(4)(B)(iii); Treas Reg §1.409A–2(a)(8).

A plan that provides for deferral of compensation that does not give the service provider an opportunity to elect the time or form of payment of the compensation must designate the time and form of payment by the later of (1) the time the service provider has a legally binding right to compensation or (2) the time the service provider would be required to make an election under IRC §409A(a)(2) if the service provider were given an election. Treas Reg §1.409A–2(a)(2).

These limitations were inspired by the spectacle of insiders at Enron withdrawing millions of dollars in deferred compensation as the company headed into bankruptcy.

Under IRC §409A(a)(4)(C), a plan may allow a participant to make a subsequent election to delay a payment previously deferred or to change the form of payment, provided that: (1) the election does not take effect until 12 months after the election is made; (2) the election extends the deferral of the payment (or, in the case of a life annuity or installment payments treated as a single payment, the first scheduled payment) for at least 5 years, except in the case of death, disability, or unforeseeable emergency; and (3) the election is made at least 12 months before the date of the payment (or, in the case of a life annuity or installment payments treated as a single payment, the first scheduled payment) is scheduled to be made. [Treas Reg §1.409A-2\(b\)\(1\)](#).

Distribution of Deferred Compensation

Under IRC §409A(a)(2)(A), distributions of deferred compensation may not, in general, be made earlier than one of the following: the date a service provider separates from service (or in the case of a key employee of a publicly traded corporation, 6 months after separation from service), becomes disabled, or dies; the time specified or pursuant to the schedule specified in the plan at the time compensation was deferred; or the occurrence of an unforeseeable emergency. [Treas Reg §1.409A-3\(a\)](#). These limitations were inspired by the spectacle of insiders at Enron withdrawing millions of dollars in deferred compensation as the company headed into bankruptcy. Amounts are considered payable “at a specified time or pursuant to a fixed schedule if objectively determinable amounts are payable at a date or dates that are nondiscretionary and objectively determinable” at the time the amounts are deferred. [Treas Reg §1.409A-3\(i\)\(1\)](#).

Deferred compensation also may be distributed on a change in ownership or effective control of a corporation or in the ownership of a substantial portion of its assets as defined in [Treas Reg §1.409A-3\(i\)\(5\)](#) (collectively, a change-in-control event). [Treas Reg §1.409A-3\(a\)\(5\)](#).

Acceleration of Deferred Compensation

Under IRC §409A(a)(3), a nonqualified deferred compensation plan may not permit the acceleration of payments except as provided in Treasury Regulations. See [Treas Reg §1.409A-3\(j\)\(4\)](#) for exceptions, e.g., domestic relations orders, limited cash-out payments, payment of employment taxes, and plan terminations.

NONQUALIFIED DEFERRED COMPENSATION PLAN

Under [Treas Reg §1.409A-1\(c\)\(1\)](#):

The term *plan* includes any agreement, method, program, or other arrangement, including an agreement, method, or program, or other arrangement that applies to one person or individual. A plan may be adopted unilaterally by the service recipient or may be negotiated or agreed to by the service recipient and one or more service providers.

Service Providers Subject to IRC §409A

Under [Treas Reg §1.409A-1\(f\)\(i\)](#), service providers subject to IRC §409A include individuals and entities that account for income from the performance of services under the cash method of accounting. Independent contractors, as well as employees and directors, are included, except independent contractors (1) actively engaged in the trade or business of providing services other than as an employee or member of the board of directors or management of an entity, (2) that provide significant services (as defined in [Treas Reg §1.409A-1\(f\)\(iii\)](#)) to two or more unrelated service recipients, (3) where they are unrelated to the service recipient, and (4) not providing management services to the service recipient. [Treas Reg §1.409A-1\(f\)\(2\)](#). Thus, a plan of deferred compensation can be found in a plan of an employer covering multiple employees or independent contractors, an individual employment or consulting contract, or an ad hoc arrangement with one or more employees or independent contractors to defer compensation.

Treatment as Separate Plan for Each Service Provider and Aggregation of Plans of Same Type

Under [Treas Reg §1.409A-1\(c\)\(1\)](#): “The requirements of section 409A are applied as if a separate plan or plans is maintained for each service provider.” Thus, a violation of IRC §409A in the operation of a plan with respect to a single service

provider will only trigger tax consequences with respect to that service provider. However, a failure of a plan covering multiple service providers to satisfy the formal requirements of IRC §409A will trigger tax consequences with respect to all of them.

All deferrals of compensation of a service provider under plans of a service recipient of the same type—e.g., account balance plans, non-account balance plans, and stock right plans—are aggregated and treated as deferred under a single plan. *Treas Reg §1.409A-1(c)(2)*.

Service Recipient's Deduction

Under IRC §404(a)(5), nonqualified deferred compensation is deductible by the employer or service recipient in the year in which it is includable in income by the service provider, provided that, if a plan is one in which more than one employee participates, a separate account is maintained for each employee.

When a Plan Provides for Deferral of Compensation

Under *Treas Reg §1.409A-1(b)(1)*, as a general rule:

a plan provides for the deferral of compensation if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable to (or on behalf of) the service provider in a later taxable year.

Under a broad anti-abuse rule contained in *Treas Reg §1.409A-1(a)(1)*:

if a principal purpose of a plan is to achieve a result with respect to a deferral of compensation that is inconsistent with the purposes of section 409A, the Commissioner may treat the plan as a nonqualified deferred compensation plan for purposes of section 409A and the regulations thereunder.

Exception for Short-Term Deferrals

There is an exception for short-term deferrals, which provides that a deferral of compensation does not occur if compensation is received by a service provider within 2 months and 15 days after the end of the taxable year of the service provider or the service recipient, whichever is later, in which the compensation is no longer subject to a substantial risk of forfeiture. *Treas Reg §1.409A-1(b)(4)(i)*. Thus, an agreement to pay a bonus no later than 2 months and 15 days after the end of the taxable year of the em-

ployer in which the bonus vests (March 15 of the following year in the case of a calendar-year taxpayer) does not create a plan of deferred compensation subject to IRC §409A.

FUNDING RULES

Section 409A(b) generally treats an employer or service recipient's transfer of assets to a foreign trust for purposes of paying deferred compensation (or a restriction of assets to the payment of deferred compensation that is triggered by a change in a service recipient's financial health) as a transfer of an economic benefit or property for purposes of IRC §83, whether or not the assets are subject to the service recipient's general creditors.

The Pension Protection Act of 2006 (Pub L 109-280, 120 Stat 780) amended IRC §409A(b) to require covered employees of a plan sponsor of a defined benefit pension plan and covered employees of a member of a controlled group that includes such a plan sponsor to include in gross income amounts set aside or reserved for them under nonqualified deferred compensation plans during the period when the defined benefit plan was in at-risk status within the meaning of IRC §430(i) (generally, less than 80-percent funded) or the plan sponsor was in bankruptcy, or during the 12-month period beginning 6 months before the termination of the plan without having sufficient assets to pay all benefits owed. IRC §409A(b)(3).

The amendment treats any payment by the employer of the employee's tax liability with respect to such amounts as payment of nonqualified deferred compensation subject to the interest charge and additional 20-percent tax imposed by IRC §409A(a)(1)(B), and denies the employer a tax deduction for the payment. Covered employees are the CEO and the four other most highly compensated employees, as provided by the definition of "covered employee" in IRC §162(m)(3), and any employees subject to the short-swing profit rule of §16(a) of the Securities Exchange Act of 1934 (15 USC §78p(a)).

APPLICATION OF §409A TO STOCK RIGHTS

The regulations treat certain stock options and stock appreciation rights (collectively "stock rights") as involving deferral of compensation for purposes of IRC §409A. *Treas Reg §1.409A-1(b)(5)*.

This is of crucial importance because a stock option plan will rarely satisfy the requirements of IRC §409A inasmuch as stock option holders under most

stock option plans are free to determine when to exercise their options. This is often true of stock appreciation rights holders and stock appreciation rights plans.

The result of inadvertent violation of [IRC §409A](#) for an employee or independent contractor granted stock options or stock appreciation rights would be tax on ordinary income equal to either the fair market value or the intrinsic value of the stock options or rights, *i.e.*, the excess of the fair market value of the stock subject to the options or rights over the exercise price of the options or rights at the time the options or rights vested, plus an additional tax equal to 20 percent of the income inclusion. The regulations reserve questions concerning the calculation of the income inclusion. [Treas Reg §1.409A-4](#).

The result of the violation also could be the loss by the employer of the benefit of a deduction for compensation if the employer has failed to file with the IRS and furnish the employee or independent contractor with a timely [Form W-2](#) or [Form 1099-MISC](#), as the case may be, reporting the compensation ([Treas Reg §§1.83-6\(a\)\(2\)](#), [1.6041-2](#)), or if the year in which the deduction should have been taken is closed for tax purposes at the time the mistake is discovered by the employer. The statute of limitations for federal income tax refund claims is generally 3 years from the date the return is filed. [IRC §6511\(a\)](#).

What Stock Rights Are Treated as Providing Deferral of Compensation?

Stock options and stock appreciation rights that do not provide for deferral of compensation are discussed below. Other stock rights issued in connection with the performance of services will generally involve the deferral of compensation for purposes of [IRC §409A](#). [Treas Reg §1.409A-1\(b\)\(5\)\(i\)\(C\)](#).

Stock Options

Under [Treas Reg §1.409A-1\(b\)\(5\)\(i\)\(A\)](#), a non-qualified option to acquire stock of a service recipient does not provide for deferral of compensation if (1) the exercise price of the option may never be less than the fair market value of the underlying stock (disregarding lapse restrictions under [Treas Reg §1.83-3\(i\)](#)) on the date the option is granted and the number of shares subject to the option is fixed on the date of grant of the option, (2) the transfer or exercise of the option is subject to taxation under [IRC §83](#) and [Treas Reg §1.83-7](#), and (3) the option does not include any feature for the deferral of compensation other than deferral of recognition of income un-

til the later of the exercise or the disposition of the option under [Treas Reg §1.83-7](#), or the time the stock acquired on exercise of the option becomes substantially vested. The transfer and exercise of a stock option issued in connection with services is subject to taxation under [IRC §83](#) unless it is an incentive stock option under [IRC §422](#) or an option issued under an employee stock purchase plan described in [IRC §423](#). [Treas Reg §1.83-7\(a\)](#).

... IRC §409A applies to “backdated” options and other mispriced options issued to employees at a below-market price.

The IRS has stated that [IRC §409A](#) applies to “backdated” options and other mispriced options issued to employees at a below-market price. See [Notice 2006-79](#), [2006-43 Int Rev Bull 763](#); [Announcement 2007-18](#), [2007-9 Int Rev Bull 625](#); [IRS News Release IR-2007-30](#) (discussed below).

The grant of an incentive stock option described in [IRC §422](#) or the grant of an option under an employee stock purchase plan described in [IRC §423](#) does not constitute a deferral of compensation. [Treas Reg §1.409A-1\(b\)\(5\)\(ii\)](#).

Stock Appreciation Rights

Under [Treas Reg §1.409A-1\(b\)\(5\)\(i\)\(B\)](#), a right to compensation equal to the appreciation in value of a specified number of shares of stock of a service recipient does not provide for deferral of compensation if (1) the compensation payable under the stock appreciation right cannot be greater than the difference between the fair market value of the stock (disregarding lapse restrictions under [Treas Reg §1.83-3\(i\)](#)) on the date the right is exercised and an amount specified on the date of grant of the right (the stock appreciation right exercise price) with respect to a number of shares fixed on or before the date of grant of the right, (2) the stock appreciation exercise price may never be less than the fair market value of the underlying stock (disregarding lapse restrictions under [Treas Reg §1.83-3\(i\)](#)) on the date the right is granted, and (3) the stock appreciation right does not include any feature for the deferral of compensation other than deferral of recognition of income until the exercise of the right.

Features for the Deferral of Compensation/Rights to Dividends

To the extent that a stock right includes a right other than the right to receive cash or stock on the date of exercise and this additional right allows compensation to be deferred beyond the date of exercise, the stock right is treated as providing for the deferral of compensation and is subject to IRC §409A. *Treas Reg §1.409A-1(b)(5)(i)(D)*. The right to receive non-vested stock on the exercise of a stock right and the right to pay the exercise price with previously acquired shares are not treated as features that allow compensation to be deferred. *Treas Reg §1.409A-1(b)(5)(i)(D)*.

The right to dividends on the shares underlying a stock right (other than an increase in the shares subject to the right to reflect a stock split or stock dividend), if the right to dividends is contingent on the exercise of the stock right, is a feature that makes the stock right subject to IRC §409A. *Treas Reg §1.409A-1(b)(5)(E)*. The right to dividends on the shares underlying a stock right, if it is not contingent on the exercise of the stock right, may provide for the deferral of compensation, but is not treated as a feature that makes the stock right subject to IRC §409A. *Treas Reg §1.409A-1(b)(5)(i)(E)*.

What Is “Stock of a Service Recipient”?

Stock rights will not qualify as exempt under the foregoing rules unless the stock subject to the right is “stock of a service recipient.” *Treas Reg §1.409A-1(b)(5)(iii)*. Stock of a service recipient for purpose of these rules means a class of stock that as of the date of grant is common stock for purposes of IRC §305 of an eligible issuer of service recipient stock. Under *Treas Reg §1.305-5(a)*, preferred stock, in contrast to common stock, is stock that has certain limited rights and privileges but does not participate in corporate growth to any significant extent. Stock of a service recipient may not have any preference as to distributions other than distributions of service recipient stock and distributions in liquidation of the issuer. It may not be subject to a mandatory repurchase obligation (other than a right of first refusal) or a put or call right that is not a lapse restriction under *Treas Reg §1.83-3(i)* if the stock price under that obligation or right is not fair market value (disregarding lapse restrictions under *Treas Reg §1.83-3(i)*). *Treas Reg §1.409A-1(b)(5)(iii)(A)*.

An eligible issuer of service recipient stock is the corporation for which the services were performed (if the services were performed for a corporation) and any corporation in a chain of corporations or other

entities above the corporation or entity for which the services were performed in which each corporation or other entity has a controlling interest in another corporation or other entity in the chain. “Controlling interest” for this purpose has the meaning set out in *Treas Reg §1.414(c)-2(b)(2)(i)*, provided that “at least 50 percent” is to be substituted for “at least 80 percent” each place it appears in the regulation and where the use of the stock is based on legitimate business criteria, as in a joint venture, “at least 20 percent” is to be substituted for “at least 80 percent” each place it appears in the regulation. *Treas Reg §1.409A-1(b)(5)(iii)(E)(1)*. The regulation states:

The determination of whether a grant is based on legitimate business criteria is based on the facts and circumstances, focusing primarily on whether there is a sufficient nexus between the service provider and the issuer of the stock right so that the grant serves a legitimate non-tax business purpose other than simply providing compensation to the service provider that is excluded from the requirements of section 409A.... [W]here a service provider has no real nexus with a corporate venturer, such as generally happens when the corporate venturer is a passive investor in the service recipient joint venture, a stock right issued to that employee on the investor corporation's stock generally would not be based upon legitimate business criteria.

An eligible issuer of stock of a service recipient does not include any corporation whose primary purpose is to serve as an investment vehicle for minority ownership interests in entities other than the service recipient, if the service provider is not performing services for that corporation. *Treas Reg §1.409A-1(b)(5)(iii)(E)(2)*. An eligible issuer of stock of a service recipient does not include any corporation in a group of entities treated as a single service recipient under *Treas Reg §1.409A-1(b)(5)(iii)(E)(1)* if a purpose of the ownership structure or of a significant transaction between two or more entities comprising the group is to provide for the deferral of compensation not subject to the application of IRC §409A. *Treas Reg §1.409A-1(b)(5)(iii)(E)(3)*. If the primary source of income or value of an entity that becomes a member of such a group is providing management services to other members of the group, there is a presumption that the ownership structure was established for the purpose of avoiding the application of IRC §409A if stock rights are issued by that entity. *Treas Reg §1.409A-1(b)(5)(iii)(E)(3)*.

When the substitution of stock rights in a corporate transaction is not considered the grant of a new stock right (see below), the definition of service recipient stock is modified in *Treas Reg §1.409A-1(b)(5)(iii)(E)(4)* to cover the stock underlying the

substituted stock rights if it otherwise satisfies the requirements of [Treas Reg 1\(b\)\(5\)\(iii\)\(A\)](#) (discussed above).

The use of a value previously calculated is not reasonable as of a later date if the value does not reflect material developments after that date

Valuation of Readily Tradable Stock

The fair market value of service recipient stock that is readily tradable on an established securities market may be determined based on the last sale before or the first sale after the grant, the closing price or the arithmetic mean of the high and low prices on the trading day before or the trading day of the grant, or any other reasonable basis using actual transactions in the stock as reported by that market. The determination of fair market value also may be based on an average selling price during a specified period that is within 30 days before or 30 days after the grant, provided that the program under which the stock right is granted, including a program with a single participant, must irrevocably specify the commitment to grant the stock right with such an exercise price before the beginning of the specified period. [Treas Reg §1.409A-1\(b\)\(5\)\(iv\)\(A\)](#).

Valuation of Not Readily Tradable Stock

The fair market value of service recipient stock that is not readily tradable on an established securities market may be determined by the reasonable application of a reasonable valuation method. [Treas Reg §1.409A-1\(b\)\(5\)\(iv\)\(B\)\(1\)](#).

Reasonable Application of Reasonable Valuation Method

The determination of whether a valuation method is reasonable, or whether an application of a valuation method is reasonable, is based on the facts and circumstances as of the valuation date. [Treas Reg §1.409A-1\(b\)\(5\)\(iv\)\(B\)\(1\)](#). The regulation states:

Factors to be considered under a reasonable valuation method include, as applicable, the value of tangible and intangible assets of the corporation, the present value of anticipated future cash-flows of the corporation, the market value of stock or equity interests in similar corporations and other entities engaged in trades or businesses substantially similar to those engaged in by the corporation the stock of which is to be valued, the value of which can be

readily determined through objective means (such as through trading prices on an established securities market or an amount paid in an arm's length private transaction), recent arm's length transactions involving the transfer of such stock or equity interests, and other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation method is used for other purposes that have a material economic effect on the service recipient, its stockholders or its creditors. The use of a valuation method is not reasonable if such valuation method does not take into consideration in applying its methodology, all available information material to the value of the corporation.

The use of a value previously calculated is not reasonable as of a later date if the value does not reflect material developments after that date or if this value was calculated more than 12 months earlier. [Treas Reg §1.409A-1\(b\)\(5\)\(iv\)\(B\)\(1\)](#). A service recipient's consistent use of a valuation method to determine the value of its stock or assets for purposes other than the compensation of service providers is a factor supporting the reasonableness of the valuation method. [Treas Reg §1.409A-1\(b\)\(5\)\(iv\)\(B\)\(1\)](#).

Presumptively Reasonable Valuation Methods

The regulations provide that the use of any of the following three methods of valuation of not readily tradable stock is presumed to result in a reasonable valuation, but that the IRS can rebut the presumption by a showing that the method or its application was grossly unreasonable ([Treas Reg §1.409A-1\(b\)\(5\)\(iv\)\(B\)\(2\)](#)):

(1) Valuation determined by an independent appraisal that meets the requirements of [IRC §401\(a\)\(28\)\(C\)](#) and the regulations for valuing stock for Employee Stock Ownership Plans (ESOPs), provided the valuation is as of a date that is no more than 12 months before the grant date of the stock rights.

(2) Valuation based on a generally applicable buy-back formula, provided that this formula price is applicable to all transactions with the issuer or any person owning 10 percent or more of its stock, except an arm's-length transaction involving the sale of all or substantially all of the stock of the issuer.

(3) Reasonable and good faith valuation evidenced by a written report that takes into account the relevant factors described above of "illiquid stock of a start-up corporation."

A "start-up corporation" for purposes of the last method is a corporation that has no material trade or business that it or any predecessor to it has conducted for a period of 10 years or more. To qualify for this method, the corporation must have no class of equity

securities that are traded on an established securities market. This method may not be used if the stock is subject to any put or call right or obligation of the service recipient or other person to purchase the stock (other than a right of first refusal on an offer to purchase by a third party that is unrelated to the service recipient or service provider and other than a right or obligation that will lapse). [Treas Reg §1.409A-1\(b\)\(5\)\(iv\)\(B\)\(2\)\(iii\)](#).

This method also may not be used if the service recipient or service provider reasonably anticipates that the service recipient will undergo a change-in-control event (as defined in [Treas Reg §1.409A-3\(i\)\(5\)](#)) within 90 days or make a public offering of securities within 180 days. [Treas Reg §1.409A-1\(b\)\(5\)\(iv\)\(B\)\(2\)\(iii\)](#).

A renewal of a stock right that has the same effect as an extension is treated as an extension.

A valuation will not be treated as made reasonably and in good faith for purposes of this method unless it is performed by a person (or persons) that the corporation reasonably determines is qualified to make the valuation based on his or her significant knowledge, experience, education, or training. [Treas Reg §1.409A-1\(b\)\(5\)\(iv\)\(B\)\(2\)\(iii\)](#). The regulation states:

Generally, a person will be qualified to perform such a valuation if a reasonable individual, upon being apprised of such knowledge, experience, education, and training, would reasonably rely on the advice of such person with respect to valuation in deciding whether to accept an offer to purchase or sell the stock being valued. For this purpose, significant experience generally means at least five years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry in which the service recipient operates.

Modification or Extension of Stock Rights

Any modification of the terms of a stock right or of the terms of the plan under which it was granted that grants the holder directly or indirectly a reduction in the exercise price is considered the grant of a new stock right for purposes of [IRC §409A](#). [Treas Reg §1.409A-1\(b\)\(5\)\(v\)\(A\)-\(B\)](#). Whether a new stock right involves a deferral of compensation and is, therefore, subject to [IRC §409A](#) is determined as of the date of the modification. [Treas Reg §1.409A-1\(b\)\(5\)\(v\)\(A\)](#).

An extension of a stock right (as defined in [Treas Reg §1.409A-1\(b\)\(5\)\(v\)\(C\)](#)) results in the right being treated as subject to [IRC §409A](#) from the original date of grant. [Treas Reg §1.409A-1\(b\)\(5\)\(v\)\(A\)](#).

Substitution of Stock Rights

The substitution of new stock rights for old stock rights in a merger generally is not considered a modification if the spread between the aggregate fair market value of the shares subject to the stock rights and the aggregate exercise price of the stock rights is not increased, and if the other requirements of [Treas Reg §1.424-1](#) to avoid the substitution of incentive stock options being treated as the grant of new incentive stock options are met, except the requirement that an eligible corporation be the employer of the optionee. [Treas Reg §1.409A-1\(b\)\(5\)\(v\)\(D\)](#).

Change in Underlying Stock

A change in the terms of the stock subject to a stock option that increases the value of the stock is otherwise treated as the grant of a new stock option. [Treas Reg §1.409A-1\(b\)\(5\)\(v\)\(G\)](#).

Definition of Extension

[Treasury Regulation §1.409A-1\(b\)\(5\)\(v\)\(C\)](#) defines an extension of a stock right as including: (1) providing the holder an additional period of time within which to exercise the stock right, (2) the conversion or exchange of a stock right for a legally binding right to compensation in a future taxable year, or (3) the addition of any feature for the deferral of compensation not permitted in the definitions of stock rights not subject to [IRC §409A](#) unless the exercise price of the stock right equals or exceeds the fair market value of the service recipient stock. A renewal of a stock right that has the same effect as an extension is treated as an extension. [Treas Reg §1.409A-1\(b\)\(5\)\(v\)\(C\)](#). An extension of the exercise period of a stock right to a date no later than the earlier of the (1) latest date on which the stock right could have expired by its original terms under any circumstances, or (2) the 10th anniversary of the original date of grant of the stock right, is excepted from the definition of an extension. [Treas Reg §1.409A-1\(b\)\(5\)\(v\)\(C\)](#). The extension of the exercise period of a stock right at a time when the exercise price of the stock right equals or exceeds the fair market price value of the service recipient stock subject to the stock right is treated as the grant of a new stock right. [Treas Reg §1.409A-1\(b\)\(5\)\(v\)\(C\)](#).

Discretionary Added Benefits

A change in a stock right that provides that the holder may at the discretion of the grantor receive a benefit in the future that would constitute a modification or extension constitutes a modification or extension at the time the right is changed to give the grantor such discretion. [Treas Reg §1.409A-1\(b\)\(5\)\(v\)\(F\)](#).

Rescission of Changes

A modification or extension of a stock right can be rescinded without tax consequences before the right is exercised if the rescission occurs in the same calendar year as the modification or extension. [Treas Reg §1.409A-1\(b\)\(5\)\(v\)\(I\)](#).

Definitions

Date of Grant of Option

The date of grant of an option is defined as “when the granting corporation completes the corporate action necessary to create the legally binding right constituting the option.” [Treas Reg §1.409A-1\(b\)\(5\)\(vi\)\(B\)\(1\)](#). The regulation states:

A corporate action creating the legally binding right constituting the option is not considered complete until the date on which the maximum number of shares that can be purchased under the option and the minimum exercise price are fixed or determinable, and the class of underlying stock and the identity of the service provider is designated. Ordinarily, if the corporate action provides for an immediate offer of stock for sale to a service provider, or provides for a particular date on which such offer is to be made, the date of the granting of the option is the date of the corporate action if the offer is to be made immediately, or the date provided as the date of the offer, as the case may be. However, an unreasonable delay in the giving of notice of such offer to the service provider will be taken into account as indicating that the corporation provided that the offer was to be made at the subsequent date on which such notice is given.

A condition on the granting of an option as opposed to its exercise will be taken into account in determining the date of grant, except for a condition that it be approved by the shareholders, which will be ignored in determining the date of grant. [Treas Reg §1.409A-1\(b\)\(5\)\(vi\)\(B\)\(2\)](#). A condition not requiring corporate action, such as the approval of, or registration with, a regulatory or government agency, *e.g.*, a stock exchange or the Securities and Exchange Commission, is considered a condition of exercise unless it is clearly made a condition of grant. [Treas Reg §1.409A-1\(b\)\(5\)\(vi\)\(B\)\(2\)](#).

Analogous rules apply with respect to the date of grant of a stock appreciation right. [Treas Reg §1.409A-1\(b\)\(5\)\(vi\)\(H\)](#).

Other Definitions

There are also definitions of “stock,” “exercise price,” “exercise,” “transfer,” and “readily tradable.” [Treas Reg §1.409A-1\(b\)\(5\)\(vi\)\(C\)–\(G\)](#).

Restricted Property

A service recipient’s issue to a service provider of restricted (*i.e.*, substantially nonvested) stock or of a legally binding right to obtain restricted stock in the future does not involve the deferral of compensation subject to [IRC §409A](#) unless it is combined with another legally binding right that constitutes a deferral of compensation. [Treas Reg §1.409A-1\(b\)\(6\)](#).

PARTNERSHIPS AND PARTNERS

The regulations reserve the question of the application of [IRC §409A](#) to partnerships and partners. [Treas Reg §1.409A-1\(b\)\(7\)](#).

Under [Notice 2005-1, Q&A-7](#), and the preamble to the final regulations, taxpayers may apply the principles that govern the issue of stock to the issue of a partnership interest (including a profits interest) granted in connection with the performance of services and the principles applicable to stock rights to equivalent rights with respect to partnership interests. [TD 9321, Explanation of Provisions and Summary of Comments, Part III\(G\), 2007-19 Int Rev Bull 1133](#).

Under the preambles to the proposed and final regulations, [IRC §409A](#) applies to a guaranteed payment to a partner (and the right to receive a guaranteed payment in the future), only when it is for services and the partner does not include the payment in income within 2 months and 15 days of the end of the taxable year of the partner in which the partner obtained a legally binding right to the payment or, if later, the taxable year in which the right to the payment was first no longer subject to a substantial risk of forfeiture. [2007-19 Int Rev Bull 1134](#).

Under [Notice 2005-1, Q&A-7](#), and the preamble to the final regulations, taxpayers may treat payments subject to [IRC §736](#) (payments to a retiring partner or a deceased partner’s successor in interest) and the right to receive such payments as not subject to [IRC §409A](#), except for payments described in [IRC §1402\(a\)\(10\)](#). [2007-19 Int Rev Bull 1134](#).

EFFECTIVE DATE AND TRANSITION RELIEF

Section 409A applies in general to amounts deferred under a nonqualified deferred compensation arrangement in taxable years beginning after December 31, 2004 (*i.e.*, earned and vested after that date) and to amounts deferred in taxable years beginning before January 1, 2005, if the plan under which they were deferred is materially modified after October 3, 2004. [Treas Reg §1.409A-6\(a\)\(1\)\(i\)](#), [\(a\)\(2\)](#). A modification of a plan is material if a benefit or right existing on October 3, 2004, is materially enhanced or a new material benefit or right is added, whether it occurs pursuant to an amendment of the plan or the service recipient's exercise of discretion under the terms of the plan, and the modification affects amounts earned and vested before January 1, 2005. [Treas Reg §1.409A-6\(a\)\(4\)\(i\)](#). However, it is not a material modification for a service recipient to exercise discretion over the time and manner of payment of benefits to the extent that the plan, as of October 3, 2004, provided for the exercise of such discretion. [Treas Reg §1.409A-6\(a\)\(4\)\(i\)](#).

The modification, extension, or renewal of a stock right is not treated as a material modification if it would not be treated as the grant of a new stock right under [Treas Reg §1.409A-1\(b\)\(5\)\(v\)\(A\)](#) or an extension under [Treas Reg §1.409A-1\(b\)\(5\)\(v\)\(C\)](#) (discussed above). [Treas Reg §1.409A-6\(a\)\(4\)\(v\)](#).

A material modification is ignored if it is rescinded by the earlier of the date before a discretionary right created by the modification is exercised or the last day of the taxable year of the service provider in which the change occurred. [Treas Reg §1.409A-6\(a\)\(4\)\(vi\)](#).

Section 409A applies to earnings on amounts deferred only if it applies to the amounts deferred. [Treas Reg §1.409A-6\(a\)\(1\)](#). For this purpose, an increase in the amount of payment pursuant to a stock right due to appreciation in the underlying stock, or accrual of other earnings such as dividends, is treated as earnings on the amount deferred. [Treas Reg §1.409A-6\(a\)\(3\)\(iv\)](#).

Section 409A does not apply to amounts deferred under bona fide collectively bargained agreements in effect on October 3, 2004, for the period ending on the earlier of the date on which the last of such agreements terminates (determined without regard to extensions after October 3, 2004) or December 31, 2009. [Treas Reg §1.409A-6\(a\)\(1\)\(ii\)](#).

Plans Adopted Before December 31, 2007

[Notice 2005-1](#), [2005-2 Cum Bull 274](#), as amplified and extended by the preamble to the proposed regulations, provided that a plan adopted on or before December 31, 2006, would not be treated as violating [IRC §409A](#) if the plan was operated in good faith compliance with the provisions of [IRC §409A](#) and [Notice 2005-1](#) or the proposed regulations under [IRC §409A](#) in 2005 and 2006, and the plan was amended on or before December 31, 2006, to comply with the terms of [IRC §409A](#) and the final regulations. Final regulations were not issued in 2006.

[Notice 2006-79](#), [2006-43 Int Rev Bull 763](#), extended this transition relief through 2007. It provides that a plan adopted on or before December 31, 2007, will not be treated as violating [IRC §409A\(a\)\(2\)](#), [\(3\)](#), or [\(4\)](#) on or before December 31, 2007, if it is operated through December 31, 2007, in reasonable, good faith compliance with the provisions of [IRC §409A](#), the applicable provisions of [Notice 2005-1](#) or the proposed regulations, and any other generally applicable guidance, and the plan is amended on or before December 31, 2007, to conform to the provisions of the final regulations under [IRC §409A](#). The preamble to the final regulations provides that nothing in the preamble or the final regulations is intended to restrict otherwise applicable transition relief. [TD 9321](#), [Explanation of Provisions and Summary of Comments, Part XII\(A\)](#), [2007-19 Int Rev Bull 1165](#).

Discounted Stock Rights

[Notice 2005-1](#), [Q&A 18\(d\)](#), and the preamble to the proposed regulations ([Explanation of Provisions, Part XI\(H\)](#), [REG-158080-04](#), [2005-2 Cum Bull 786](#), 815) permitted the substitution of nondiscounted stock options and stock appreciation rights for discounted stock rights before December 31, 2006, among other grants of transition relief, but provided that the exercise of a discounted stock right in 2006 would violate [IRC §409A](#). The IRS notice and the preamble also provided guidance as to how service recipients could compensate service providers for the lost discount without violating [IRC §409A](#). Whether a stock right was discounted for these purposes is determined as of the date of the original grant. The discount could not be paid in cash in 2006 without violating [IRC §409A](#), but it could be made up in restricted stock or a promise to pay the lost discount (plus earnings) subject to the same vesting schedule as the substituted stock right.

[Notice 2006-79](#), [§3.04](#), extended this transition relief through 2007, but the transition relief was not

extended with respect to discounted stock rights ([Notice 2006-79, §3.07](#)):

- That were granted with respect to stock of a corporation that, as of the date of grant, had issued any class of common stock required to be registered under [§12 of the Securities Exchange Act of 1934 \(15 USC §77I\)](#);
- That were granted to an insider subject to the disclosure requirements of [§16\(a\) of the Securities Exchange Act of 1934 \(15 USC §77p\(a\)\)](#); and
- With respect to which the issuer has reported or reasonably expects to report a financial expense “due to the issuance of a stock right with an exercise price lower than the fair market value of the underlying stock on the date of grant that was not timely reported on financial statements or reports for the period in which the related expense should have been reported under generally accepted accounting principles.”

The IRS has announced that it will allow companies to pay the additional 20-percent tax and interest tax owed by rank-and-file employees on discounted stock options and stock appreciation rights that were exercised in 2006, but the IRS initiative does not permit the company to pay the additional tax for stock rights exercised in 2006 by its top executives or other insiders subject to the disclosure requirements of [§16\(a\) of the Securities Exchange Act of 1934](#). The discount was typically attributable to backdating. For example, an option with an exercise price of \$20 per share issued on a date when the fair market value was \$25 per share, backdated to a date when the fair market value was \$20 per share, that was vested on December 31, 2005, and exercised in 2006 when the fair market value was \$30 per share, would result in \$10 per share of income to the employee and an additional tax of \$2 per share plus an interest tax. According to the Announcement, the interest tax equals the amount of interest at the underpayment rate plus 1 percent on the underpayment of federal income tax that would have occurred had the excess of the fair market value of the underlying stock over the sum of the exercise price and any amount paid by the employee for the stock option been includable in gross income on December 31, 2005, and been taxable at the highest marginal rate of 35 percent. The employee remains obligated to pay the full amount of income tax due on the exercise of the option, including any due on the addi-

tional gain realized from backdating, whether or not the employee was aware of the backdating, as well as income tax due on the compensation realized by the employee from the employer’s payment of the [§409A](#) taxes. Under the plan aggregation rules, employees who exercised discounted stock rights of an employer in 2006 and held other vested discounted stock rights of the employer will have to recognize the deferred compensation attributable to the vested and unexercised stock rights under [IRC §409A](#) in 2007 if these are not replaced before the end of 2007 with nondiscounted stock rights. [Announcement 2007-18, 2007-9 Int Rev Bull 625; IRS News Release IR-2007-30](#).

Under [Notice 2006-100, 2006-51 Int Rev Bull 1109](#), service recipients are generally required to report amounts includable by service providers under [IRC §409A](#) for 2006 on [Forms W-2 or 1099](#), as applicable.

Valuation and Service Recipient Stock

Under [Notice 2006-4, 2006-3 Int Rev Bull 307](#), for stock rights issued before January 1, 2005, the exercise price will be treated as set at or above fair market value if based on a good faith attempt of the issuer to set the exercise price at or above fair market value. Under [Notice 2006-4](#), for stock rights issued after January 1, 2005, and before January 1, 2008, the provisions of [Notice 2005-1, Q&A-4\(d\)\(ii\)](#), requiring the issuer to use a reasonable valuation method in setting the exercise price of stock rights apply. Taxpayers may also rely on the provisions of the proposed or final regulations in valuing stock underlying stock rights issued before January 1, 2008. [TD 9321, Explanation of Provisions and Summary of Comments, Part XII\(C\), 2007-19 Int Rev Bull 1165](#).

Under the preamble to the final regulations, when stock rights have been issued before April 10, 2007, on stock that would have constituted service recipient stock under a reasonable good faith interpretation of [IRC §409A](#) and applicable guidance, but that would not constitute service recipient stock under the final regulations, that stock will continue to constitute service recipient stock for purposes of applying [IRC §409A](#) to these stock rights (but not stock rights issued after April 10, 2007) until the exercise or termination of the rights, or until the stock rights are modified in a manner that is treated as the grant of new rights. [2007-19 Int Rev Bull 1166](#).

