April 15, 2005

The Honorable Mark W. Everson  
Commissioner of Internal Revenue  
Internal Revenue Service  
Room 5226  
1111 Constitution Avenue, NW  
Washington, DC 20224  

Re: Comments on Section 409A Regarding its Impact on Business Transactions

Dear Commissioner Everson:

Enclosed are comments on Section 409A regarding its impact on business transactions. These comments represent the individual views of those members who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

Sincerely,

Kenneth W. Gideon  
Chair, Section of Taxation

Enclosure

cc: Carol Gold, Director – TEGE Employee Plans, IRS  
Nancy Marks, Division Counsel/Associate Chief Counsel – TEGE, IRS  
Stephen Tackney, Attorney, Office of Division Counsel/Associate Chief Counsel – TEGE, IRS  
William Bortz, Associate Benefits Tax Counsel, Treasury  
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COMMENTS ON CODE SECTION 409A
REGARDING ITS IMPACT ON BUSINESS TRANSACTIONS

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Employee Benefits Committee of the Section of Taxation. Principal responsibility was exercised by John R. Cornell. Substantive contributions were made by John E. Aguirre, Benjamin Ferrucci, Mark C. Jones, Michael Montfort, John L. Utz, Wayne R. Luepker, Jeremy L. Goldstein and Mark A. Vogel. The comments were reviewed by Wayne R. Luepker, Chair of the Subcommittee on Executive Compensation, Greta E. Cowart and Priscilla E. Ryan, Vice Chair and Chair respectively of the Section’s Employee Benefits Committee; by the Quality Assurance Group of the Employee Benefits Committee, which is chaired by Thomas R. Hoecker and whose members are former chairs of the Committee; by T. David Cowart of the Section’s Committee on Government Submissions; and by Thomas A. Jorgensen, Council Director for the Employee Benefits Committee.

Although many of the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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COMMENTS ON CODE SECTION 409A REGARDING ITS IMPACT ON BUSINESS TRANSACTIONS

I. EXECUTIVE SUMMARY

The following comments pertain to IRS Notice 2005-1, addressing Section 409A of the Internal Revenue Code of 1986, as amended. All Section references are references to the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

Our recommendations regarding future notices or regulations (“Regulations”) to be published by the U.S. Department of Treasury (the “Treasury”) with respect to Section 409A are as follows:

1. We recommend that the substitution, assumption or modification of an option or other equity award pursuant to a merger, acquisition, joint venture or similar transaction not be treated as the grant of new deferred compensation or a change in form of payment for purposes of Section 409A if (i) such substitution, assumption or modification is not subject to the discretion of the employee, (ii) the terms of the substitution, assumption or modification are determined solely by the employer or jointly by the employer and the other parties to the transaction or by operation of law, and (iii) similar terms apply to all employer award holders.

2. We recommend that the substitution of cash for an option pursuant to a transaction be treated as a disposition of the option under Treasury Regulation § 1.83-7, and that the substitution of cash for other equity awards pursuant to a transaction not be treated as an acceleration or change in form of payment if such substitution meets the conditions of Recommendation 1 above and is permitted under the terms of the applicable plan.

3. We recommend that the substitution of a stock appreciation right (a “SAR”) or an assumption of a SAR pursuant to a merger, acquisition, joint venture or similar transaction not be treated as the grant of a new SAR or a change in form of payment for purposes of Section 409A, if (i) such substitution or assumption is not subject to the discretion of the employee, (ii) the terms of the substitution or assumption are determined solely by the employer or jointly by the employer and the other parties to the transaction, and (iii) all employees with SARs are treated similarly.

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4. We recommend that the substitution of cash for a SAR pursuant to a transaction not be treated as the acceleration or change in form of payment if such substitution meets the conditions of Recommendation 3 above and is permitted under the terms of the applicable plan.

5. We recommend that the exemption for certain cash-settled SARs be extended to equity appreciation rights that relate to an equity traded on an established securities market that is not common stock, such as publicly-traded partnership interests.

6. We recommend that if a corporate event causes a SAR to fail to comply with Section 409A, interest should be imposed only from the later of (i) the date of the corporate event or (ii) vesting.

7. We recommend that, where the stock to which a SAR relates is not traded on an established securities market, the methodologies provided under Section 422 and Treasury Regulation § 1.422-2(e)(2) for determining fair market value of the underlying stock apply in valuing the SAR for purposes of Q&A-4(d)(iv).

8. We recommend that material modifications to SARs (or economically equivalent rights) related to corporate events after October 3, 2004 have no effect on the SARs’ ability to enjoy the temporary exemption from the requirements of Section 409A.

9. We recommend that the temporary grandfather rule for SARs in effect on or before October 3, 2004 be expanded to include other equity appreciation rights where the temporary grandfather rule would be available but for the fact that the appreciation rights relate not to stock but instead to other equity interests of the service recipient.

10. We recommend that additional consideration payable to employee-shareholders with respect to their shares in a corporate transaction (whether restricted or unrestricted), which is conditioned upon the absence of undisclosed liabilities of the seller or upon the achievement of financial milestones or other conditions unrelated to the performances of services, be deemed to be subject to a substantial risk of forfeiture for purposes of Section 409A if the payment condition is applied equally to employee-shareholders and other selling shareholders of the same class.

11. We recommend that no deferral of compensation be deemed to occur where the payment in cash or stock for restricted stock units or other derivative equity awards in a portfolio company is conditioned on and occurs at the time of a liquidity event.

12. We recommend that it be clarified that additional credited shares arising from adjustments to the number of credited shares based upon stock dividends, property dividends or reorganizations, are also grandfathered.
from Section 409A, the same as any future appreciation in the shares under Notice 2005-1.

13. We recommend that the Service confirm that the statement in Q&A-11 of Notice 2005-1 providing that a payment will be treated as occurring upon a change in control event if the compensation is distributed within 12 months of a change in control means within 12 months before or after a change in control as opposed to 12 months after a change in control.
II. BACKGROUND

Notice 2005-1 provides initial guidance under Section 409A. Our comments on Notice 2005-1 and recommendations for future notices or regulations follow.

III. COMMENTS

We appreciate the opportunity to comment on Notice 2005-1. We commend the efforts of the Treasury and the Internal Revenue Service to provide comprehensive rules in light of the complex statutory changes effecting deferred compensation.

A. Adjustments of Equity Compensation (other than SARs) Pursuant to a Corporate or Similar Transaction

1. Summary

Q&A-4(d)(ii) of Notice 2005-1 provides that the substitution of a new option for an outstanding option or the assumption of an outstanding option pursuant to a corporate transaction will not be treated as the grant of a new option or a change in form of payment for purposes of Section 409A if the substitution or assumption satisfies Treasury Regulation § 1.424-1. Notice 2005-1 does not address the substitution or assumption of equity awards other than options, nor does it specifically address the distribution of cash in exchange for an equity award pursuant to a transaction or the modification of equity awards in connection with a transaction.

2. Recommendations

We recommend that the substitution of an option or other equity award, an assumption of an option or other equity award or modification of an option or other equity award pursuant to a merger, acquisition, joint venture or similar transaction, regardless of whether the substitution, assumption or modification complies with Treasury Regulation § 1.424-1, not be treated as a new deferral of compensation, the grant of a new option or award or a change in form of payment for purposes of Section 409A, if (i) such substitution, assumption or modification does not occur as the result of an exercise of discretion by the employee, (ii) the terms of the substitution, assumption or modification are determined solely by the employer or jointly by the employer and the other parties to the transaction, and (iii) similar terms apply to all employee award holders. We also recommend that the substitution of cash for an option pursuant to a transaction be treated as a disposition of the option under Treasury Regulation § 1.83-7, and that the substitution of cash for other equity awards pursuant to a transaction not be treated as an acceleration or change in form of payment, even if the option or equity award is cashed out early, if such substitution for other equity awards meets the conditions of the preceding sentence and is permitted under the terms of the applicable plan.

3. Explanation

Q&A-4(d) of Notice 2005-1 excludes from the definition of “deferred compensation” incentive stock options, options granted under a Section 423 stock purchase plan, and nonstatutory options under Section 83 that are not offered at a discount or with deferral rights. The exception for nonstatutory options states that the substitution of a new option pursuant to a...
A corporate transaction for an outstanding option or the assumption of an outstanding option will not be treated as a new grant or change in form under Section 409A if the substitution or assumption would comply with Treasury Regulation § 1.424-1 if the option were a statutory option. Treasury Regulation § 1.424-1 provides that such substitution or assumption of an option by an employer corporation (or a related corporation) by reason of a corporate transaction will not be treated as a modification, and, thus, a grant of a new option if (a) the employee’s rights under the old option are canceled, (b) the aggregate spread (the difference between the fair market value of the underlying stock at the time of exercise and the exercise price) immediately after the substitution or assumption is not greater than the aggregate spread immediately before the substitution or assumption, (c) on a share by share comparison, the ratio of exercise price to the fair market value of the underlying stock immediately after the substitution or assumption (adjusted for the number of shares subject to the option) is not more favorable than the ratio of exercise price to the fair market value of the underlying stock immediately before the substitution or assumption, (d) the new or assumed option contains all terms of the old option, and (e) the new option or assumed option does not give the employee additional benefits.

We believe that Treasury Regulation § 1.424-1 contains restrictions that do not advance the purpose of Section 409A and would cause many commonplace adjustments of equity awards required to preserve award holders’ relative economic interests in the course of a transaction to run afoul of Section 409A. For example, Section 424 is limited to corporations, and therefore does not apply to transactions involving partnerships, many limited liability companies or joint ventures. Section 424 also does not cover the substitution of cash for an option, even where the substitution is not within the option holder’s control. In addition, the requirement that the new option contain all terms of the old option and no new benefits generally prohibits the grant of the substituted or assumed option under the purchasing employer’s existing option plan. On the other hand, a purchasing employer’s assumption of a target’s option plan creates unnecessary administrative burdens and may subject the plan to new board and shareholder approval requirements under the Securities Exchange Act of 1934, stock exchange listing requirements or state law. For a purchasing employer that does four or five deals each year, a requirement to maintain each target’s plan or the terms of the options granted under each such plan could result in the employer having to administer 20 to 30 different sets of option provisions with 20 to 30 different sets of definitions of “change in control,” “competition,” or “termination with cause.” This would be administratively difficult and unduly burdensome, if not impossible. Section 409A should not operate in a manner that discourages the substitution or assumption of options in arm’s length transactions. Legislative history to Section 409A suggests that Congress was concerned about options granted at a discount or with deferral features. (H.R. Rep. No. 108-755, 108th Cong., 2d Sess. (2004) at 735.)

While the rigidity of Section 424 may be appropriate to limit the extension of preferential tax treatment for incentive stock options, the wider scope and more severe consequences of Section 409A merit greater flexibility. Section 424 was intended to apply to a narrow subset of compensatory stock options that enjoy partial relief from ordinary income tax. There is no penalty for violation of Section 424; rather, the converted option simply becomes subject to the same tax regime under Section 83 as all other options. Notice 2005-1, however, effectively extends Section 424 to all compensatory options, and applies a severe financial penalty to conversions that fail to comply with Section 424’s myriad requirements. Therefore, we believe that the Treasury should apply only those restrictions on option conversion that will further the

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policy behind the deferred compensation rules - limiting an employee’s “inappropriate control or access to amounts deferred”, and regulating the grant of options at a discount and the use of substituted or assumed options to manipulate the spread. H.R. Rep. No. 108-393, 108th Cong., 1st Sess. (2003) at 89. The restrictions of Section 424 on transactions with non-corporate entities, the substitution of cash for the underlying stock, and the assumption of the option under the purchaser’s existing plans do not advance the goals and policies behind the deferred compensation rules described above.

Therefore, we recommend that the exception for substitution and adjustment of options set forth in Notice 2005-1, Q&A-4(d) be extended to any substitution, adjustment or modification pursuant to any merger, acquisition, joint venture or similar transaction as long as (1) the treatment is not elective on the part of the employee, (2) the terms of the substitution, adjustment or modification are determined by the employer or the parties negotiating the transaction agreement, and (3) all employee option holders are treated similarly. We believe that these restrictions will ensure that this exception is used only for legitimate business reasons and that the spirit of the deferred compensation rules — to limit an employee’s effective control over vested compensation that is enjoying deferred tax treatment — is preserved. To the extent Section 424 is applied to options, its application should be limited to the maintenance of the aggregate spread and conversion ratios provided in Treasury Regulation § 1.424-1(a)(5)(ii) and (iii), but only to the extent necessary to meet the principal concern of Q&A-4(d)(ii), granting options at fair market value. We believe that an option holder’s incentive to exploit a general exception for substitutions and adjustments is sufficiently checked by the safeguards inherent in most changes in control – specifically, the arm’s length negotiation that sets the terms of the exchange and the treatment of other shareholders of the same class. Therefore, as long as the substitution, adjustment or modification is not elective on the part of the employee, the terms are determined by the employer or the parties negotiating the transaction agreement, and all employee option holders are treated similarly, we believe that a general rule permitting such treatment will satisfy the policy behind Section 424.

We also recommend that this exception be extended to equity awards that may be considered “deferred compensation”, such as phantom shares and deferred stock units. To date, the Treasury has not provided guidance on the substitution, adjustment or modification of equity-based deferred compensation pursuant to a change in control, although they are similar in many ways to options. As with options, the disposition of equity-based awards is driven by the needs of the transaction and the needs of shareholders of the same class. Therefore, we believe that the same rules on substitution, adjustment and modification pursuant to a transaction should apply.

In addition, we recommend that the distribution of cash for an option pursuant to a corporate or similar transaction be treated as a disposition of the option under Treasury Regulation § 1.83-7, and that a similar rule be provided for the substitution of cash for other equity awards pursuant to a transaction, regardless of whether the transaction meets the requirements of a “change in control event” as set forth in Q&A-11-14, of Notice 2005-1. In an all-cash transaction, for example, this is generally the only fair way to recognize employees’ option and equity interests, and in many other transactions the purchasing employer will require the cash-out of employees’ equity awards as a means, among other reasons, to limit dilution or to prevent outstanding options and equity awards from impeding the transaction. Even when cash is substituted for equity, holding the cash pursuant to the terms of the acquired employer’s plan April 15, 2005
document will create administrative burdens because of the difficulty of administering a multitude of different plan provisions for multiple acquisitions. Further, the substitution of cash for equity changes the economic characteristics of the award, and delayed payment subjects the acquired employer’s employees to a different economic risk than intended with the original equity award. Where the distribution of cash for other equity awards that are deferred compensation does not occur as a result of an exercise of discretion by the employee, the terms of the distribution are determined solely by the employer or jointly by the employer and the other parties to the transaction, and all employee award holders receive cash distributions even if the transaction does not meet the requirements of a change in control event, the early distribution should be permitted under Section 409A(a)(3).

Legislative history to Section 409A(a)(3) suggests that regulations may provide limited exceptions to the prohibition on accelerated distributions where such distributions are not elective by, and beyond the control of, the employee. (H.R. Rep. No. 108-755, 108th Cong., 2d Sess. (2004) at 731.) Consistent with such legislative history, mandated cashouts are typically not within the control of the option holder, but are mandated by the employer or the employer and the other party to the transaction as a way of achieving a result desired by the parties to the transaction, such as maintaining a minimum ownership level, limiting the amount of outstanding shares or other reasons which cannot be achieved without cashing out the options or other awards. In most transactions, the distribution of cash for other equity awards that are deferred compensation has little potential for abuse because the cash-out is necessary to effectuate the transaction and the timing and amount of payment are determined by the entities negotiating the transactions and applied impartially. These factors hold even if the transaction does not satisfy the definition of change in control event set forth in Q&As-11 through -14, Notice 2005-1. Therefore, we believe that the same criteria recommended for substitution or assumption of an award – that the cash payment does not occur as a result of an exercise of discretion by the employee, the terms of the distribution are determined solely by the employer and the other parties to the transaction, and all employee award holders receive cash distributions – would also ensure that any substitution of cash for an equity award would be for legitimate business reasons and beyond the award holder’s control.

B. Adjustments to Stock-Settled SARs of Publicly Traded Companies Pursuant to Corporate Transactions

1. Summary

Notice 2005-1 provides, in Q&A-4(d)(iv), that a SAR will not provide for the deferral of compensation, and therefore will not be subject to Section 409A, 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) the stock of the service recipient subject to the right is traded on an established securities market, (3) only such traded stock of the service recipient may be delivered in settlement.
of the right upon exercise, 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 this Comment, the above-described exception is referred to as the “Stock-Settled SAR”. The Notice does not address how the numbered conditions above are to be interpreted where the stock underlying a SAR is affected by a corporate transaction, nor does it provide guidance on acceptable methods for determining the fair market value of the underlying stock, except the valuation method described in Treasury Regulation § 20.2031-2.

2. Recommendations

We recommend that the substitution of a SAR or an assumption of a SAR pursuant to a merger, acquisition, reorganization, recapitalization, or similar transaction not be treated as the grant of a new SAR or a change in form of payment for purposes of Section 409A if (i) such substitution or assumption is not subject to the discretion of the employee, (ii) the terms of the substitution or assumption are determined solely by the employer or jointly by the employer and the other parties to the transaction, and (iii) all employee SAR holders are treated similarly.

We recommend that the substitution of cash for a SAR pursuant to the transaction not be treated as an acceleration or change in form of payment if such substitution meets the conditions of the preceding sentence and is permitted under the terms of the applicable plan.

We also recommend that the Stock-Settled SAR exception be extended to equity appreciation rights that relate to other equities traded on an established securities market, such as publicly-traded partnership interests. We recommend that if a Corporate Event (as defined below) causes a SAR to fail to comply with Section 409A, interest should be imposed only from the later of (i) the date of the Corporate Event or (ii) vesting.

3. Explanation

If the stock underlying a SAR is no longer traded on an established securities market due to a merger, acquisition, reorganization, recapitalization, or other corporate transaction (a “Corporate Event”), then the substitution of any other stock of a corporate member of the relevant controlled group of corporations or group of trades or businesses under common control (within the meaning of Sections 414(b) and (c)) following the Corporate Event that is traded on an established securities market should not cause the SAR to fail to satisfy the publicly-traded stock requirement set forth in condition (2) of Q&A-4(d)(iv). For this purpose, the relevant controlled group of corporations or group of trades or businesses under common control would be the group of the acquiring organization (in the case of an acquisition), the surviving organization (in the case of a merger), or the resulting organization (in the case of a reorganization or recapitalization). Without such a rule, SARs not subject to Section 409A at the date of grant may become deferred compensation subject to the Section 409A rules solely by reason of a Corporate Event that was unforeseeable on the date of grant. In addition, the policy supporting the exemption for Stock-Settled SARs relating to publicly traded companies supports an extension of the exemption to equity appreciation rights relating to other publicly traded equity because similar treatment promotes fairness and tax consistency across different forms of

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business entities. Where, pursuant to a Corporate Event, the stock underlying a SAR is substituted with the stock of an acquirer, or where the number of SARs granted to an individual is adjusted on account of a Corporate Event, the SAR should not be considered to be, or to have been, issued at a discount in violation of the requirement set forth in condition (1) of Q&A-4(d)(iv) quoted above, so long as the adjustment in the number of SARs is consistent with the treatment of all outstanding shares of the same class as the stock originally underlying the SARs, and the adjustment complies with guidance relating to the aggregate spread and conversion ratios applicable to options and discussed in A.3 above.

If, due to a Corporate Event, there is no longer stock in the relevant controlled group of corporations or group of trades or businesses under common control (described in the preceding paragraph) that is traded on an established securities market, then the Corporate Event should be treated as a Change in Control Event under Section 409A(a)(2)(A)(v) or a permissible acceleration event under Section 409A(a)(3), so that settlement of the SARs may be made in cash without causing the SARs to become subject to the requirements of Section 409A. This treatment would be consistent with how other shareholders would be treated and as long as all shareholders are treated the same there is no potential abuse. The same analysis also applies and should be extended to equity appreciation rights that are traded on an established securities market that are not common stock, such as publicly traded partnership interests; the form of the entity should not make a difference, provided the entity’s equity is publicly traded.

If all of the following occur: (1) due to a Corporate Event, the stock underlying a SAR is no longer traded on an established market (2) there is no substitution (as described above) of other stock that would allow the SARs to fall within the Stock-Settled SAR exemption, (3) the SAR does not provide for distribution on account of the Corporate Event (as described above), and (4) the SAR becomes deferred compensation within the meaning of Section 409A, then interest should apply only from the date of the Corporate Event or later vesting, and not from the initial grant of the SAR (assuming the SAR previously enjoyed the exemption for Stock-Settled SARs relating to publicly traded stock). Such treatment would be consistent with Section 409A in that there is no deferral of compensation within the meaning of Section 409A until the Corporate Event, and interest would be computed under Section 409A(a)(B)(ii) only from the time the compensation is “first deferred or, if later, the first taxable year in which such deferred compensation is not subject to a substantial risk of forfeiture.” Section 409A does not contemplate the imposition of interest prior to the time there is a deferral of compensation.

C. **Temporary Grandfather Rule for SARs**

1. **Summary**

Notice 2005-1 provides, in Q&A-4(d)(iv), that:

[U]ntil further guidance is issued, a payment of stock or cash pursuant to the exercise of a stock appreciation right (or economically equivalent right), or the cancellation of such right for consideration, where such right is granted pursuant to a program in effect on or before October 3, 2004 will not be treated as a payment of a deferral of compensation subject to the requirements
of § 409A if: (1) the SAR exercise price may never be less than the fair market value of the underlying stock on the date the right is granted, and (2) 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.

The Notice does not address how taxpayers may determine the fair market value of the underlying stock for purposes of satisfying condition (1) above.

2. Recommendations

We recommend that, where the stock to which a SAR relates is not traded on an established securities market, the methodologies provided under Section 422 and Treasury Regulation § 1.422-2(e)(2) for determining the fair market value of the underlying stock should apply in valuing SARs for purposes of Q&A-4(d)(iv). We do not perceive a policy reason why methodologies relating to good faith determination of fair market value of stock for purposes of options should not be extended to SARs.

We recommend that material modifications to SARs (or economically equivalent rights) related to Corporate Events after October 3, 2004 have no effect on the SARs’ ability to enjoy the temporary exemption from the requirements of Section 409A.

We also recommend that the temporary grandfather rule for SARs in effect on or before October 3, 2004 be expanded to include other equity appreciation rights where the temporary grandfather rule would be available but for the fact that the appreciation rights relate not to stock but instead to other equity interests of the service recipient.

3. Explanation

Particularly for privately held companies, a variety of methods may be appropriate for determining the fair market value of stock underlying an SAR. To offer assurance that the temporary exemption is not inadvertently lost, a reasonable good-faith determination of value should be permitted under a standard that is consistent with rules adopted with respect to grants of nonstatutory stock options.

A modification to a SAR or economically equivalent right related to a Corporate Event occurring after October 3, 2004, should not impact a SAR’s ability to enjoy the temporary exemption from the requirements of Section 409A provided (1) the treatment is not elective on the part of the employee, (2) the terms of the substitution, adjustment or modification are determined by the employer or the parties negotiating the transaction agreement, and (3) all employee option holders are treated similarly. We believe that these restrictions will ensure that this exception is used only for legitimate business reasons and that the spirit of the deferred compensation rules — to limit an employee’s effective control over vested compensation that is enjoying deferred tax treatment — is preserved and the exception will not permit any increase in the deferral.

In addition, the policy supporting the grandfather rule for SARs supports expansion of the grandfather rule to equity appreciation rights relating to equity interests other than stock. Such
similar treatment promotes fairness and tax consistency across different forms of business entities.

D. Application of Section 409A to Delayed Transaction-Related Payments

1. Summary

It is common to structure the payment of merger consideration to selling shareholders so that a portion of the payment is delayed beyond the tax year of the closing. There are two common scenarios. In the first, a portion of the merger consideration may be withheld by the purchaser from all selling shareholders and held in an escrow account or in general assets to secure the purchaser against a breach of the representations and warranties by the seller. In the second scenario, a portion of the merger consideration becomes payable to selling shareholders only upon the achievement of financial milestones. Employees may be affected by such payment arrangements if stock options are exchanged for merger consideration. Payment of such amounts is typically not conditioned on performance of future services by the employee. Assuming such deferred payment arrangements do not result in current taxation to affected employees under current law, these arrangements nonetheless would appear to result in a deferral of compensation under Section 409A.

2. Recommendation

We recommend that additional consideration payable to employee-shareholders with respect to their shares in a corporate transaction (whether restricted or unrestricted) that is conditioned upon the absence of undisclosed liabilities of the seller, upon the achievement of financial milestones or other conditions unrelated to the performance of services be treated as subject to a substantial risk of forfeiture for purposes of Section 409A if the payment condition is applied equally to employee shareholders and other selling shareholders of the same class.

3. Explanation

Q&A-10(a) of Notice 2005-1 states that compensation is subject to a substantial risk of forfeiture if “entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition relating to the purpose of the compensation, and the possibility of forfeiture is substantial.” The Notice states further that for purposes of Q&A-10, “a condition related to the purpose of the compensation must relate to the service provider’s performance for the service recipient or the service recipient’s business activities or organizational goals (for example, the attainment of a prescribed level of earnings, equity value or a liquidity event).”

In the first scenario described in the Summary under the heading D above, Q&A-10(a) would treat deferred payments held outside of an escrow account as not being subject to a substantial risk of forfeiture for purposes of Section 409A. We note that the service provider has the same risk of nonpayment as other selling shareholders and that the underlying purpose of the arrangement is unrelated to compensation for services. In the second scenario above, Q&A-10(a) may treat the deferred payments as being subject to a substantial risk of forfeiture for purposes of Section 409A because payment of the earn-out is conditioned on the service
recipient’s achievement of financial goals. We believe both arrangements should be treated as subject to a substantial risk of forfeiture under Section 409A.

E. Equity Incentive Compensation Plans for Private Companies

1. Summary

Section 409A and Notice 2005-1 do not provide clear guidance regarding the private equity industry’s practice of conditioning the payout of granted restricted stock units in companies in which a private equity fund invests its funds (a “portfolio company”) on an event in which the portfolio company’s investors receive payment in cash or marketable securities (a “liquidity event”), which generally means a sale of the company or an initial public offering. For purposes of this comment, it is assumed that the equity compensation arrangement will explicitly specify the type of liquidity event that will trigger payment.

2. Recommendation

We recommend that no deferral of compensation be deemed to have occurred where the payment, in cash or stock, for restricted stock units or other derivative equity awards in a portfolio company is conditioned on and occurs at the time of the occurrence of a liquidity event. In the alternative, we recommend that a liquidity event be treated as permissible distribution event under Section 409A(a)(2) or a permissible acceleration event under Section 409A(a)(3), as further explained below.

3. Explanation

Private equity investors in a portfolio company commonly use restricted stock units or other derivative equity awards in the portfolio company to incentivize management toward a liquidity event. Such awards, which are not intended to create deferred compensation, could be significantly impacted by the current guidance under Section 409A.

Example. A portfolio company sponsors a long-term equity incentive plan, where non-elective grants of restricted stock units are made to eligible employees. The restricted stock units have two independent performance-related conditions which must be satisfied before the employee would receive a payout: (a) a performance hurdle (e.g., financial results over a period of 3 years based on EBITDA or similar measures) and (b) a requirement for a liquidity event to occur. If both conditions are satisfied, the compensation is immediately payable to the employee. However, if both conditions are not met, the grants arguably never vest.

We note, from a compensation perspective, it is quite common that the timing of a liquidity event may differ from the requirements relating to the performance criteria. For example, even if the EBITDA performance hurdle is satisfied, the payout will only occur upon a liquidity event. Thus, in some situations it would even be possible for the EBITDA performance hurdle to be satisfied during the employee’s continued employment, thereby arguably making the stock units vested, but for the liquidity event to be achieved at a point of time after an employee’s termination of employment.

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We believe an arrangement like the one described above is not intended to be treated as deferred compensation under Section 409A, as it is an equity compensation arrangement without any intent on the part of employees or employer to defer payout, other than contractual restrictions imposed by the employer relating to a liquidity event. In fact, most private equity investors regularly delay payment of equity remuneration to employees until such time as a liquidity event occurs, and in some instances that may be the sole condition. It is generally believed that this type of arrangement best aligns management interests with those of its shareholders.

We recommend that Regulations adopt one of the following approaches:

1. **Treat as Excluded from Section 409A.** Assuming a liquidity event is a primary objective of the compensation structure, the requirement for an expressly specified liquidity event to occur would be viewed as a “substantial risk of forfeiture” under Section 409A and Notice 2005-1, Q&A-10, and thus the entire arrangement would not be taxable until the substantial risk of forfeiture lapses, provided the requirements of Q&A-4(c) are met.

2. **Treat as subject to Section 409A.** If the condition of a liquidity event is not considered a substantial risk of forfeiture, then to avoid an adverse effect on the equity compensation plan, we propose the following two alternatives combined with the use of a fixed payment or forfeiture date (e.g., seven years from the date of grant) with acceleration of payment as follows:

   a. **Acceleration.** A liquidity event could be recognized as an appropriate trigger to accelerate distributions under Section 409A(a)(3). Note that such event is non-elective and beyond the control of the employee, and that corporate-driven decisions resulting in a liquidity event are made for corporate reasons, independent of compensation payout considerations.

   b. **Change in Control.** A liquidity event, including an initial public offering (“IPO”), could be recognized as a “change in control” under Section 409A(a)(2)(A)(v). Currently, under Q&A-13, an IPO or other public distribution of shares (e.g., to creditors) is not recognized as a change in control, yet is an event beyond the control of the employees and is clearly identifiable.

F. **Earnings of Grandfathered Account-Balance Plans**

1. **Summary**

   Adjustments to the common stock (or phantom shares) of a service recipient in grandfathered account-balance plans should also be grandfathered under Section 409A.

2. **Recommendation**

   We recommend that additional shares arising from adjustments to the number of shares credited to an individual’s account under a nonqualified deferred compensation plan that are the result of stock dividends, property dividends or reorganizations also be grandfathered under Section 409A.

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Section 409A, the same as any future appreciation in the shares under Notice 2005-1, Q&A-17(d).

3. Explanation

Most nonqualified deferred compensation plans that provide for deemed investments in company stock (or phantom shares) provide for discretionary or automatic adjustments to the number of shares credited to participants’ accounts in the event of stock dividends, property dividends or reorganizations involving the underlying stock. Such adjustments are driven by external corporate events and typically apply outside of the plans to all shareholders of the same class, with phantom shares being treated the same as shares that are issued and outstanding. Such equitable treatment is not compensatory in nature, and therefore should not create deferred compensation subject to Section 409A. Such adjustments are common in equity plans and arrangements of public and private companies and are done to balance the interests of the company, existing owners and affected grantees. To subject such adjustments to Section 409A, where the underlying compensation otherwise qualified for grandfathered status, or is otherwise exempted from Section 409A as not involving deferred compensation, would needlessly complicate administration by employers of their nonqualified deferred compensation plans as a result of events that are inherently non-compensatory and, because of differing economic interests, not generally susceptible to abuse and not disguised deferred compensation.

G. Distributions within 12 Months of a Change in Control

1. Summary.

Q&A-11 of Notice 2005-1 provides that a payment will be treated as occurring upon a change in control event if the compensation is distributed within 12 months of a change in control.

2. Recommendation.

We recommend that Regulations confirm that the statement in Q&A-11 of Notice 2005-1 that provides that a payment will be treated as occurring upon a change in control event if the compensation is distributed within 12 months of a change in control means within 12 months before or after a change in control as opposed to 12 months after a change in control.

3. Explanation.

Q&A-11 of Notice 2005-1 provides that distributions of deferred compensation are permissible if made upon a change in control event. Q&A-11 of Notice 2005-1 further provides that a payment will be treated as occurring upon a change in control event if the compensation is distributed within 12 months of a change in control. While the plain language of Q&A-11 would permit payments to be made within 12 months before or after a change in control, informal statements of representatives of the government have implied that the rule only applies to payments made within 12 months after a change in control. We believe that such an interpretation is inconsistent with the plain language of Notice 2005-1 and the legislative purposes underlying the rule permitting distributions under Section 409A in connection with a change in control. The legislative history only states, “Distributions upon a change in the

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ownership or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation, may only be made to the extent provided by the Secretary.” H.R. Conference Report No. 108-755, 108th Congress 2d Sess. (2004) at 730. The legislative history does not limit the payment on a change in control to only those occurring after the change in control.

Interpreting Q&A-11 to permit distributions within 12 months before or after a change in control provides no opportunity for abuse that is not otherwise extant with respect to change in control distributions. In addition, the apparent reason that the Notice permits distributions in connection with a change in control, and the reason that Congress authorized such distributions, is a recognition that employees of a company subject to a takeover proposal are often subjected to a great deal of pressure, including pressure caused by uncertainty about their own future if a combination takes place. To offset these pressures, most public companies have adopted compensation arrangements containing change in control provisions for their employees. Adoption of these change in control protections is largely intended to address employees’ awareness of the potential for an acquirer to refuse to pay amounts otherwise due to employees and the potential for a hostile acquirer to take economic risks with the target company that would render the target company unable to fulfill its compensatory obligations to its employees. To allay these concerns and motivate employees to focus on closing a transaction and integrating the combined company with minimized distraction, many companies as part of their change in control planning, provide for the distribution of deferred compensation within a specified period prior to a change in control.

An interpretation of Q&A-11 that would permit only distributions made within 12 months following a change in control would preclude companies from designing their compensatory arrangements in a manner that addresses two key concerns of employees in connection with a change in control: refusal of an acquirer to pay accrued amounts and inability of an acquirer to pay accrued amounts. Accordingly, we recommend that Regulations interpret Q&A-11 of Notice 2005-11 in a manner consistent with the plain language of the Notice and good compensatory policy to permit distributions of deferred compensation within 12 months before or after a change in control. By reducing the personal uncertainty and anxiety arising from a change in control, such a design would contribute to assuring full and impartial consideration of takeover proposals by a company’s management and would aid a company in attracting and retaining key employees.