

AMERICAN BAR ASSOCIATION -- SECTION OF TAXATION

*2006 Joint Fall CLE Meeting*

TITLE: Impact of § 409A Deferred Compensation Rules on Estate & Retirement Planning for Executives and Structuring the Sale or Business Succession of Closely Held Businesses

AUTHOR: Macris, Michael

PANEL: Impact of § 409A Deferred Compensation Rules on Estate & Retirement Planning for Executives and Structuring the Sale or Business Succession of Closely Held Businesses

DATE: 10/21/06

COMMITTEE: Section Program: Closely Held Businesses Committee; Business Planning Group; Employee Benefit Plans and Other Compensation Arrangements Group

NOTE: This material was produced in connection with ABA Section of Taxation and Section of Real Property, Probate and Trust Law continuing legal education programs. It represents the statements and views of the author and does not necessarily represent the official policies or positions of the American Bar Association or the ABA Sections of Taxation and Real Property, Probate and Trust Law. The American Bar Association, the Section of Taxation and the Section of Real Property, Probate and Trust Law do not accept responsibility for the accuracy of the information in this paper, nor for any interpretation or application by the reader of the information contained in this paper. This paper is not intended to be, nor should it be construed as constituting, the opinion of, or legal or tax advice with regard to specific case or transaction by the author, the Tax Section, the Real Property, Probate and Trust Law Section or the American Bar Association.

**MATERIALS FOR PROGRAM  
ENTITLED  
IMPACT OF 409A DEFERRED COMPENSATION RULES ON  
ESTATE & RETIREMENT PLANNING FOR  
EXECUTIVES AND STRUCTURING THE SALE OR  
BUSINESS SUCCESSION OF CLOSELY HELD BUSINESSES**

**October 21, 2006**

by  
Michael Macris

© Michael Macris 2006. All rights reserved.

**These materials were prepared as of September 14, 2006 before the issuance of final regulations.**

## I. Reasons for Section 409A

- A. Long dissatisfaction of Internal Revenue Service with state of the law with respect to nonqualified deferred compensation and developing practices exploiting constructive receipt principles (e.g., late deferral elections and elections as to time and form of payment, liberal withdrawal provisions, acceleration provisions tied to employer's financial condition, offshore rabbi trusts that are effectively creditor-proof). IRS blocked by Section 132 of Revenue Act of 1978.
- B. Enron and other corporate debacles provided impetus for legislative action leading to enactment of Section 409A revolutionizing rules concerning nonqualified deferred compensation (going well beyond issues raised by Enron) in American Jobs Creation Act of 2004.

## II. IRS Guidance

- A. Notice 2005-1 issued December 20, 2004 providing initial guidance in Q&A form.
- B. Proposed regulations issued on September 29, 2005.
- C. Final regulations expected in Fall 2006. Transition rules expected to be extended.
- D. Proposed regulations provide that a plan adopted on or before December 31, 2006 will be treated as complying with 409A only if it is operated in good faith compliance with 409A and Notice 2005-1 through December 31, 2006 and the plan is amended on or before December 31, 2006 to conform to 409A or so as not to provide for a deferral of compensation under 409A. To the extent an issue is not addressed in Notice 2005-1, the plan must follow a good faith, reasonable interpretation of 409A and, to the extent not inconsistent therewith, the plan's terms. Also, compliance with either the proposed regulations or final regulations will be considered good faith compliance.

## III. Plans Subject to 409A

- A. Applies to nonqualified deferred compensation plans, defined broadly to include any plan providing for deferral of compensation, including traditional nonqualified deferred compensation plans, supplemental executive retirement plans (SERPs), restricted share units, phantom stock, performance share units, severance agreements (subject to certain exceptions), stock options and stock appreciation rights (subject to certain exceptions — see XI below).
- B. The following are excluded from the category of nonqualified deferred compensation plans:
  - 1. Qualified plans.

2. Bona fide vacation leave, sick leave, compensatory time, disability pay and death benefit plans.
3. Restricted property subject to Internal Revenue Code Section 83.
4. ISOs and options under Section 423 plans (employee stock purchase plans).

#### IV. Tax Penalty for Non-Compliance

- A. Inclusion in income for federal income tax purposes of all amounts deferred under the plan for the taxable year in which the plan fails to meet the requirements of Section 409A (or is not operated in accordance with those requirements) and all prior years for the participant to whom the failure relates, to the extent such amounts are not subject to substantial risk of forfeiture.
- B. Penalty imposed on recipient equal to 20% of amount included in income.
- C. Interest at the federal underpayment rate plus 1% on underpayments that would have occurred if the deferred compensation had been included in income for federal income tax purposes for the taxable year in which it was first deferred or, if later, in the first taxable year in which it is not subject to a substantial risk of forfeiture.

#### V. Effective Date and Grandfather Rule

- A. Section 409A applies to amounts deferred after December 31, 2004.
- B. Section 409A does not apply to amounts deferred before January 1, 2005 unless the plan under which the deferral is made is materially modified after October 3, 2004. This is the grandfather rule, and benefits protected by the grandfather rule are considered grandfathered benefits. Section 409A is effective with respect to earnings on amounts deferred only to the extent Section 409A is effective with respect to the amounts deferred.
- C. Under the proposed regulations, an amount is considered deferred before January 1, 2005 if before January 1, 2005 the service provider had a legally binding right to be paid the amount, and the right to the amount was earned and vested (not subject to a substantial risk of forfeiture or a requirement to perform further services after December 31, 2004).
- D. Generally, a material modification occurs if a benefit or right existing as of October 3, 2004 is materially enhanced or a new material benefit or right is added, and such enhancement or benefit affects amounts that would otherwise be grandfathered. Such material modification may occur by plan amendment or exercise of discretion by service recipient. Changes in investment options are not a material modification (as long as any new investment option constitutes a predetermined actual investment or reasonable rate of interest).

## VI. Advantages and Disadvantages of Grandfather Rule

- A. Grandfather rule enables utilization of provisions of plan that would not be allowed under new rules (e.g., later elections as to form of payment, withdrawals with haircut).
- B. To utilize grandfather rule, it is necessary essentially to bifurcate the deferral plan with different rules applying to amounts deferred before January 1, 2005 and amounts deferred after December 31, 2004. This may entail administrative complexity and confusion for participants. Also, care must be taken not to inadvertently materially modify portion of plan relating to grandfathered benefits.
- C. Compliance with the grandfather rule may not be worth it if the grandfathered benefits already comply with Section 409A or can be made to comply without giving up too much. Also, there may be provisions of Section 409A that one might want to take advantage of which are not features of the existing deferral plan and which could not be added without a material modification (e.g., the provision allowing subsequent deferrals if made one year in advance and delays deferral for at least five years).

## VII. Transition Relief under Proposed Regulations

- A. The deadline for amending plans to comply with 409A is December 31, 2006. Plans must be operated in good faith compliance with 409A and Notice 2005-1 through December 31, 2006. See II.D. above.
- B. New payment elections allowed on or before December 31, 2006 with respect to both time and form of payment, provided amendment and election apply only to amounts that would not otherwise be payable in 2006 and do not cause an amount to be paid in 2006 that would not otherwise be payable in such year.
- C. For periods ending on or before December 31, 2006, an election as to the timing and form of a payment under a nonqualified deferred compensation plan that is controlled by an election under a qualified plan will not violate 409A (provided this is in accordance with the terms of the nonqualified deferred compensation plan as of October 3, 2004 that govern payments).
- D. A stock option or stock appreciation right that would constitute a deferral of compensation under 409A may be replaced by a stock option or stock appreciation right that would not constitute a deferral of compensation, provided the cancellation and reissuance occurs on or before December 31, 2006. The replacement may not result in a cancellation in exchange for cash or vested property in 2006.
- E. Due to delay in issuance of final regulations, transition relief is expected to be extended.

VIII. What is a deferral of compensation?

- A. A deferral of compensation exists if the service provider has a legally binding right to compensation that has not been actually or constructively received and included in income and is payable under the terms of the plan in a later year. No legally binding right exists if compensation may be reduced unilaterally or eliminated by service recipient or other person after services have been performed.
- B. Short-term deferrals are not considered a deferral of compensation for this purpose. A short-term deferral is a deferral that does not extend beyond the later of (i) the 15<sup>th</sup> day of the third month following the service provider's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture or (ii) the 15<sup>th</sup> day of the third month following the end of the service recipient's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture. A payment made after the 2 1/2 month deadline may continue to qualify as a short-term deferral if the taxpayer establishes that it was administratively impracticable or would have jeopardized the company's solvency, this was unforeseeable, and payment is made as soon as reasonably practicable.
- C. A legally binding right to deferred compensation may exist even if there is a substantial risk of forfeiture.

IX. Substantial Risk of Forfeiture

- A. Under proposed regulations, compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on performance of substantial future services or occurrence of a condition related to the purpose of the compensation, and the possibility of forfeiture is substantial. This is narrower than the Internal Revenue Code Section 83 definition. For a condition to be related to the purpose of the compensation, it must relate to the service provider's performance for the service recipient or the service recipient's business activities or organizational goals.
- B. Any addition of a substantial risk of forfeiture after the legally binding right to the compensation is created, or any extension of the period during which the compensation is subject to a substantial risk of forfeiture, is disregarded for purposes of determining whether there is a substantial risk of forfeiture for purposes of 409A.
- C. A stock option or stock appreciation right is treated as not subject to a substantial risk of forfeiture at the earlier of (i) the first date the holder may exercise the stock option or stock appreciation right and receive cash or substantially vested property or (ii) the first date the stock option or stock appreciation right is not subject to a forfeiture condition that would constitute a substantial risk of forfeiture.
- D. If the service provider owns a significant amount of the total combined voting power or value of all classes of equity of the service recipient or its parent, the de-

termination of whether there is a substantial risk of forfeiture will be based on all relevant facts and circumstances.

X. Continued Relevance of Traditional Constructive Receipt Rules

- A. Traditional constructive receipt rules continue to operate.
- B. Section 409A does not replace traditional 409A rules but imposes its own conditions that must be met to avoid immediate taxation and penalties.

XI. Potential Application of 409A to Stock Options and Stock Appreciation Rights

- A. Stock Options: Stock options (other than ISOs and Section 423 options) would be considered nonqualified deferred compensation subject to 409A under the proposed regulations unless all of the following conditions are met:
  - 1. Exercise price may never be less than fair market value of stock (disregarding lapse restrictions) on grant date,
  - 2. The number of shares subject to option must be fixed on grant date,
  - 3. Transfer or exercise of option must be subject to taxation under Internal Revenue Code Section 83 and the regulations thereunder dealing with stock options, and
  - 4. The option may not contain any deferral feature (other than deferral of income until exercise or disposition of option, or vesting of stock acquired upon exercise).
- B. Stock Appreciation Rights (SARs): SARs would be considered deferred compensation subject to 409A under the proposed regulations unless all of the following conditions are met:
  - 1. Compensation payable under the SAR may not be greater than the difference between the fair market value of the stock (disregarding lapse restrictions) on the grant date and the fair market value of the stock (disregarding lapse restrictions) on the exercise date with respect to the number of shares fixed on or before the grant date,
  - 2. The SAR exercise price may never be less than fair market value of the underlying stock (disregarding lapse restrictions) on the grant date, and
  - 3. The SAR may not contain any deferral feature (other than deferral of income until exercise).
- C. A stock option or SAR will constitute a deferral of income if the stock covered by the option or SAR is not service recipient stock. Service recipient stock is generally stock that, on the grant date, is common stock of a corporation that is a ser-

vice recipient or any member of its controlled group<sup>a</sup> that is readily tradable on an established securities market or, if none, that class of common stock of such corporation having the greatest aggregate value of common stock issued and outstanding of such corporation, or common stock with substantially similar rights to stock of such class (disregarding any difference in voting rights). Preferred stock does not qualify as service recipient stock. In addition, stock subject to a mandatory repurchase obligation or put or call right that is not a lapse restriction and is based on a measure other than fair market value (disregarding lapse restrictions) does not qualify as service recipient stock.

D. The right to receive dividends upon exercise of a stock option or SAR for the period from the grant date to the exercise date would constitute an offset of the exercise price under the option or increase in the amount payable under the SAR (causing the option or SAR to be subject to and almost certainly violate 409A). However, this will not be true if the dividends are payable under separate arrangement that complies with 409A. Thus, the dividends could not be payable upon exercise of the option or SAR.

E. Determination of the Fair Market Value

1. In the case of stock that is readily tradable on an established securities market, the fair market value of the stock may be determined based upon the last sale before or the first sale after the grant, the closing price on the trading day before or the trading date of grant, or any other reasonable basis using actual transactions in such stock as reported by the market and consistently applied. The fair market value may also be determined based upon an average selling price during a specified period that is within 30 days before or 30 days after the grant, provided the commitment to make the grant based on such valuation method is irrevocable before the beginning of the specified period, and the valuation method is used consistently for grants of stock rights under the same and substantially similar programs.

2. If the stock is not readily tradable on an established securities market, the fair market value must be determined by reasonable application of a reasonable valuation method. This is based on the facts and circumstances as of the valuation date. The proposed regulations include as factors to be

---

<sup>a</sup> The determination of the members of the controlled group is made pursuant to Internal Revenue Code Sections 414(b) and 414(c) but 50% may be substituted for 80% ownership in the test, and may be reduced to 20% where the grant is based on legitimate business criteria such as where stock of a corporation participating in a joint venture is used in connection with an option or SAR of an employee who is a former employee of the corporation and who becomes an employee of the joint venture.



considered, as applicable: the value of tangible and intangible assets of the corporation, the present value of future cash-flows of the corporation, the market value of stock or equity interests in similar corporations and other entities engaged in substantially similar trades or businesses the value of which can be readily determined through objective means (e.g., through trading prices on an established securities market or in an arm's-length private transaction), 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 corporation, its stockholders or creditors. There is a presumption of reasonableness for the consistent use of a valuation method if (i) the value is determined by an independent appraisal meeting certain requirements as of a date that is no more than 12 months before the relevant transaction, (ii) the valuation is based on a formula that, if used as part of a nonlapse restriction with respect to the stock, would be considered to be the fair market value under the regulations under Internal Revenue Code Section 83 (provided the stock is valued in the same manner consistently for other purposes), or (iii) in the case of certain illiquid stock of a start-up corporation, the valuation is made reasonably and in good faith by a person with significant knowledge and experience or training and evidenced by a written report taking into account specified relevant factors. IRS Notice 2006-4 provides additional interim guidance with respect to the valuation of stock not readily tradable on an established securities market.

- F. A modification of a stock option or SAR, other than an extension or renewal, is considered the granting of a new option or SAR. For this purpose, the term "modification" means any change in the terms of the option or SAR that may provide the holder with a direct or indirect reduction in the exercise price, or an additional deferral feature, or an extension of renewal.
- G. If a stock option or SAR is extended or renewed, it is treated as having an additional deferral feature on the grant date (causing it to be nonqualified deferred compensation for purposes of 409A and almost certainly violating 409A). It is not an extension if the exercise period is extended to a date no later than the later of the 15<sup>th</sup> day of the third month following the date at which, or December 31 of the calendar year in which, the option or SAR would have expired if it had not been extended, based on the term of the option or SAR at the original grant date.
- H. A substitution of a new stock right pursuant to a corporate transaction for an outstanding stock right or the assumption of an outstanding stock right pursuant to a corporate transaction is not treated as the grant of a new stock right or a change in the form of payment for purposes of 409A if it meets the ISO requirements for such substitutions or assumptions. The ISO modification requirement relating to the ratio of exercise price to fair market value before and after the change is treated as satisfied for purposes of 409A if the ratio of the exercise price to the fair market value of the shares subject to the option or SAR immediately after the

substitution or assumption is not greater than the ratio of the exercise price to the fair market value immediately before the substitution or assumption.

- I. An acceleration of the time at which a stock option or SAR may be exercised is not a material modification for purposes of 409A.

## XII. Partnership Interests

- A. Notice 2005-1 provides that, until further guidance is issued, taxpayers may treat the issuance of a partnership interest (including a profits interest), or an option to purchase a partnership interest, granted in connection with the performance of services under the same principles that govern the issuance of stock and stock options.
- B. The proposed regulations do not address partnership interests or options to purchase partnership interests, but the preamble permits reliance on Notice 2005-1 through 2006.