CHAPTER 6

Analysis, Best Practices and Proposals for Pragmatic Interpretive Relief Regarding Three Common IRC Section 409A Practice Conundrums: Short-Term Deferral Application, Stock-Option/SAR Cash-Outs and Liquidity Event Payments

Laurence Seymour*

Synopsis

¶ 600 INTRODUCTION

- **¶ 600.1 Brief History of Key Deferred Compensation Regulation Since 1978**
- **¶ 600.2 Legislative Intent and Policy Goals Associated With the Implementation of IRC Section 409A**
- **¶ 600.3 Preliminary Notes**

¶ 601 SHORT-TERM DEFERRAL EXCEPTION (STDE) AND VARIABLE VESTING DATES

- **¶ 601.1 Overview of Relevant STDE Provisions**
- **¶ 601.2 Impact of Uncertainty Regarding Variable Vesting Dates**
- **¶ 601.3 Discussion and Analysis**
- **¶ 601.4 Significant Conflicts in Available Guidance**
- **¶ 601.5 Assessment of Key Policy Goals Applicable to the STDE**
- **¶ 601.6 Practical Application and Best Practices Under Current Law**
- **¶ 601.7 Proposed Relief**

¶ 602 POST-TRANSACTION CASH-OUTS OF STOCK OPTIONS AND STOCK APPRECIATION RIGHTS

---

* Laurence Seymour is a Partner in the Tax Department of Latham & Watkins LLP specializing in the practice of executive compensation and employee benefits law. Special thanks to William Kessler for his invaluable research and editorial assistance.

¶ 602.1 Overview of Applicable Regulatory Provision
¶ 602.2 Current Impact of Issue
¶ 602.3 Discussion and Analysis
¶ 602.4 Absence of Published Guidance
¶ 602.5 Key Policy Considerations Around Extensions
¶ 602.6 Practical Application and Best Practices Under Current Law
¶ 602.7 Proposed Relief
¶ 603 LIQUIDITY EVENT PAYMENT TRIGGERS
¶ 603.1 Overview of Applicable Regulatory Provisions
¶ 603.2 Discussion and Analysis
¶ 603.3 IPO Should Qualify as a Permissible Deferred Compensation Payment Event
¶ 603.4 CIC Should Qualify as a Vesting Condition
¶ 603.5 Limited Official Interpretations
¶ 603.6 Key Policy Considerations Around Payment Events
¶ 603.7 Best Practices Under Current Guidance
¶ 603.8 Proposed Relief

¶ 600 INTRODUCTION

Internal Revenue Code Section 409A (together with the regulations and other official guidance promulgated thereunder, "***IRC Section 409A***") was enacted in late 2004 to provide a framework for the taxation of nonqualified deferred compensation. Despite substantial efforts by the IRS and Treasury, including multiple sets of voluminous proposed and final regulations, various official US Internal Revenue Service ("IRS") notices (including multiple formal "corrections" programs)[1] and an untold number of speeches, meetings, Joint Committee on Employee Benefits ("***JCEB***") Q&As and informal discussions, uncertainty and structuring conundrums continue to dominate compensation planning as a result of IRC Section 409A.[2]

---

[1] *See, e.g.*, TD 9321, 2007-1 CB 1123; Further Guidance on the Application of Section 409A to Nonqualified Deferred Compensation Plans, 73 Fed Reg 74,380 (proposed Dec 8, 2008); Application of Section 409A to Nonqualified Deferred Compensation Plans, 70 Fed Reg 57,930 (proposed Oct 4, 2005); IRS Notice 2010-80, 2010-51 IRB 853; IRS Notice 2010-6, 2010-3 IRB 275; IRS Notice 2009-92, 2009-52 IRB; IRS Notice 2009-42, 2009-25 IRB 1093; IRS Notice 2008-115, 2008-2 CB 1367; IRS Notice 2008-113, 2008-2 CB 1305; IRS Notice 2007-100, 2007-2 CB 1243; IRS Notice 2007-89, 2007-2 CB 998; IRS Notice 2007-86, 2007-2 CB 990; IRS Notice 2007-78, 2007-2 CB 780; IRS Notice 2007-34, 2007-1 CB 996; IRS Notice 2006-100, 2006-2 CB 1109; IRS Notice 2006-79, 2006-2 CB 763; IRS Notice 2006-64, 2006-2 CB 88; IRS Notice 2006-33, 2006-1 CB 754; IRS Notice 2006-4, 2006-1 CB 307; IRS Notice 2005-94, 2005-2 CB 1208; IRS Notice 2005-1, 2005-1 CB 274.

[2] Indeed, one observer notes that "[t]he intricacy [of IRC Section 409A] means that taxpayers lose the flexibility to structure deferred compensation arrangements that best meet their legitimate business objectives, while the complexity means that even careful, well-advised taxpayers may commit costly technical violations." Gregg D. Polsky, *Fixing Section 409A: Legislative and Administrative Options*, 57 VILL L REV 635, 636 (2012). Another goes even further: "Although the government intended to squeeze

Accordingly, additional clarification of the application of IRC Section 409A is needed in many areas.

Compensation that violates the applicable provisions of IRC Section 409A is subject to: (i) taxation at the time that the compensation becomes vested, regardless of whether and when it is ultimately paid; (ii) an additional 20% federal income tax (above and beyond ordinary income and employment taxes); (iii) premium underpayment interest at the underpayment rate plus one percentage point from the year in which such amount was first includible in income; and (iv) in certain cases, additional state taxes that mimic the operative provisions of IRC Section 409A (collectively, "***IRC Section 409A Penalties***").[3] Due to the severity of the IRC Section 409A Penalties and the binary nature of their application, certain perfectly legitimate, non-abusive compensation practices are eschewed in practice due to uncertainty.[4]

This Article will describe and analyze three common practice conundrums arising from regulatory ambiguities under IRC Section 409A, note best practices in light of the absence of clear guidance and propose interpretive clarifications that are consistent with IRC Section 409A policy goals. Specifically, this Article will address: (i) the proper application of the short-term deferral exception (the "***STDE***") to payments with variable (event-based) vesting dates; (ii) the cash-out of stock options and stock appreciation rights ("***SARs***") on post-closing vesting dates in the context of merger and acquisition transactions; and (iii) the viability of initial public offerings and changes in control as payment events in certain contexts.

The simple clarifications proposed in this Article would help reduce or eliminate this uncertainty in three key areas of compensation planning involving legitimate, non-abusive compensation practices.

¶ 600.1 Brief History of Key Deferred Compensation Regulation Since 1978

In order to assess the proposed interpretive clarifications discussed in this Article, we must consider the legislative intent and policy goals that IRC Section 409A was

---

any possible ambiguity out of the regulations, the approach had the opposite effect: Ambiguity is the one reliable constant as the rules, exceptions, counter-rules, and counter-exceptions pile up, trip over each other, and pull in different directions." Michael Doran, *Time to Start Over on Deferred Compensation*, 118 TAX NOTES 1311, 1313 (2008). Doran goes on to note that the government's current "no-rule position" on the regulations exacerbates the issue. *See id.* at 1315.

[3] *See* IRC § 409A(a)(1) (2006). California, for example, mirrors the federal penalty provisions under IRC Section 409A but with the additional income tax limited to 5%. Assembly B 1173, 2013–2014 Leg, Reg Sess (Cal 2013).

[4] This reality has fueled arguments that the law is unnecessarily broad and draconian and should be repealed as poor policy. *See, e.g.*, Dana L. Trier, *Rethinking the Taxation of Nonqualified Deferred Compensation: Code Sec. 409A, the Hedging Regulations and Code Sec. 1032*, TAXES, Mar 2006, at 152.

enacted to address and assess the consistency of the proposed clarifications therewith. The following overview of the recent history of nonqualified deferred compensation regulation provides context for this IRC Section 409A policy assessment.

A. 1978 Proposed Treasury Regulations

Until 1978, court cases and rulings generally governed the various aspects of income inclusion timing relating to compensation (including, among others, the doctrines of constructive receipt and economic benefit). In 1978, to provide consistency as to the taxation of deferred income, the IRS issued Prop. Treas. Reg. § 1.61-16 (the "***1978 Proposed Regulations***"), which generally provided that if a taxpayer could elect to defer compensation to a taxable year later than that in which such amount would have been payable absent such election, the amount would be treated as received by the taxpayer and thus taxable in such earlier taxable year.[5] By contrast to IRC Section 409A, these regulations attempted to neutralize any tax benefits associated with deferred compensation arrangements rather than distinguish between "good" and "bad" arrangements. Some have argued that neutralization of potential tax benefits (rather than the penalization of "bad" deferred compensation arrangements, as provided under IRC Section 409A) would be preferable from a tax policy perspective;[6] however, such a dramatic shift in tax policy would require repeal of IRC Section 409A, analysis of which is beyond the scope of this Article.

B. Revenue Act of 1978

Section 132 of the Revenue Act of 1978[7] ("***Section 132***") overrode the 1978 Proposed Regulations, providing instead that the year of inclusion under a private deferred compensation plan would be determined in accordance with the principles set forth in regulations, rulings and judicial decisions relating to deferred compensation that were in effect prior to enactment of the 1978 Proposed Regulations. Section 132 effectively overrode the 1978 Proposed Regulations and legislatively mandated a moratorium on any regulation of constructive receipt and income deferral issues (other than judicial rulings). This moratorium perpetuated an absence of clear and consistent authority and resulted in uncertainty and varying practices in compensation planning.

---

[5] Prop Treas Reg § 1.61-16, 43 Fed Reg 4638 (Feb 3, 1978).

[6] *See, e.g.*, Doran, *supra* note 2, at 1312. This position was also taken by the Joint Committee on Taxation in its report on tax and compensation issues relating to Enron. *See* STAFF OF THE JOINT COMM. ON TAXATION, JCS-3-03, REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS 635 (2003) [hereinafter "***JCT Enron Report***"] (noting that taxing income when earned and vested (regardless of funded status) "would result in a better measure of income than under present-law rules," but would require a significant change in policy).

[7] Revenue Act of 1978 § 132, Pub L No 95-600, 92 Stat 2763, 2782–83.

C. Case Law and Rulings Prior to the Enactment of IRC Section 409A

Following the enactment of Section 132, taxpayers relied on existing constructive receipt rulings and further tested the limits of constructive receipt in the courts for support of the following key practice points: (i) re-deferral of amounts could avoid constructive receipt and defer taxation as long as the amounts were undeterminable at the time of re-deferral or the individual otherwise did not have an unfettered ability to receive the payments; (ii) the right to accelerate the payment of a deferred amount would not give rise to constructive receipt so long as the individual had to relinquish a valuable right to accelerate the payment (*e.g.*, a 10% reduction of the payment, commonly referred to as a "haircut"); and (iii) deferred amounts were not currently includible in income if payable from funds that were subject to the claims of creditors.[8] The courts generally agreed with these propositions and construed constructive receipt principles narrowly, helping to create an environment in which deferred compensation "abuses" flourished, including re-deferrals, "haircuts" and offshore trusts that were subject to (but often beyond the reach of) creditors. These practices would later form the basis of some of the key policy justifications for the enactment of IRC Section 409A (as discussed below).

D. IRC Section 409A

Congress reversed course from its regulatory moratorium and voted to enact IRC Section 409A in late 2004, largely in response to perceived abuses at Enron Corporation, in particular, (i) the accelerated payout of deferred compensation accounts on the eve of bankruptcy, and (ii) certain stock option deferral practices.[9] IRC Section 409A defines nonqualified deferred compensation to include "a legally binding right during a taxable year to compensation that . . . is or may be payable . . . in a later taxable year."[10] While IRC Section 409A regulations and other applicable guidance do exclude certain types of compensation that technically fall within this definition from their compliance requirements,[11] the scope of IRC Section 409A

---

[8] *See, e.g.*, Minor v United States, 772 F2d 1472 (9th Cir 1985); Commr v Oates, 207 F2d 711 (7th Cir 1953); Goldsmith v United States, 586 F2d 810 (Ct Cl 1978); Martin v Commr, 96 TC 814 (1991); Robinson v Commr, 44 TC 20 (1965); Sproull v Commr, 16 TC 244 (1951), *affd per curiam*, 194 F2d 541 (6th Cir 1952); Veit v Commr, 8 TCM (CCH) 919 (1949); Veit v Commr, 8 TC 809 (1947); Rev Proc 71-19 1971-1 CB 698, *amplified by* Rev Proc 92-65, 1992-2 CB 428; Rev Rul 69-650, 1969-2 CB 106; Rev Rul 69-49, 1969-1 CB 138, *superseded by* Rev Rul 69-474, 1969-2 CB 105; Rev Rul 60-31, 1960-1 CB 174, *modified by* Rev Rul 70-435, 1970-2 CB 100.

[9] The Joint Committee on Taxation's report on abuses at Enron is widely accepted is a key impetus to the passage of IRC Section 409A. *See, e.g.*, Polsky, *supra* note 2, at 641–42; Trier, *supra* note 4, at 141, 151.

[10] Treas Reg § 1.409A-1(b)(1) (2007).

[11] For example, tax-qualified retirement plans and incentive stock options, certain separation pay

pursuant to this definition is still extremely broad. As a result, IRC Section 409A captures numerous types of compensation not previously considered to constitute nonqualified deferred compensation (*e.g.*, annual bonuses, various equity awards, transaction incentives, consultant fees, commissions, etc.).

¶ 600.2 Legislative Intent and Policy Goals Associated With the Implementation of IRC Section 409A

Indications of legislative intent and policy goals associated with IRC Section 409A are found in a variety of legislative and regulatory sources and vary somewhat from one to another—following are the key sources and their stated policy goals.

A. Enron Report

As noted, the JCT Enron Report provided the initial impetus for the deferred compensation reform contemplated by IRC Section 409A, making the following specific recommendations with respect to deferred compensation regulation: (i) repeal Section 132 of the Revenue Act of 1978 and allow the IRS to issue guidance on deferred compensation to limit abuses; (ii) disallow (by imposing constructive receipt upon) arrangements that permit "haircut" distributions;[12] (iii) consider limitations on the availability of "rabbi trusts" generally; (iv) impose current inclusion on arrangements that permit participant-directed investment;* (v) impose constructive receipt on amounts that are eligible for re-deferral* or, in the alternative, limit such opportunities; (vi) disallow deferrals of gains on stock options and restricted stock; and (vii) require reporting of deferred compensation amounts.[13]

B. House Ways & Means Committee

The House Ways and Means Committee identified the following key congressional policy concerns to be addressed by IRC Section 409A: (i) availability of only limited specific guidance with respect to common deferral techniques; (ii) improper deferral techniques; (iii) inappropriate levels of retained control over payment timing by participants in deferred compensation arrangements; (iv) unavailability of rabbi trust assets held outside of the US to satisfy creditor claims, including due to offshore

---

arrangements, certain health and welfare benefits, certain foreign plans and other limited types of arrangements are excluded from the application of the deferred compensation rules under IRC Section 409A. *See generally* Treas Reg §§ 1.409A-1 to -3; Prop Treas Reg § 1.409A-4, 73 Fed Reg 74,380 (Dec 8, 2008).

[12] Restrictions and limitations on participant control under nonqualified deferred compensation plans were viewed as illusory by the authors of the JCT Enron Report. Haircuts did not discourage withdrawals and participants had significant control over investment decisions and changes in deferral elections. JCT Enron Report, *supra* note 6, at 629–30.

[13] JCT Enron Report, *supra* note 6, at 635–37. Policy goals noted with an asterisk were not ultimately addressed by IRC Section 409A, as enacted.

funding arrangements; and (v) substantial risks of forfeiture (vesting conditions) that are illusory in nature.[14]

C. Additional IRC Section 409A Policy Sources

A 2006 Joint Committee on Taxation report noted that IRC Section 409A was enacted to address inappropriate degrees of security and control over deferred amounts.[15] The IRS has also discussed certain pertinent IRC Section 409A policy concerns, including vesting conditions that do not constitute *bona fide* "substantial risks of forfeiture"[16] and excessive control over payment timing.[17] Commentators have summarized certain IRC Section 409A policy goals as well, including (i) the curtailing of both abusive deferral practices and manipulation of the timing of income recognition, while not unduly restricting legitimate and nonabusive compensatory practices;[18] and (ii) the elimination of "haircuts" and bringing of order to the constructive receipt rules.[19]

D. IRC Section 409A Policy Goal Summary

For purposes of the practice conundrums addressed by this Article, the relevant IRC Section 409A policy goals can be distilled as follows (referred to below as the "***Key Policy Goals***"):

- Disallow abusive payment acceleration provisions (*e.g.*, "haircut" payouts);
- Disallow illusory vesting conditions;
- Limit abusive "re-deferrals" of compensation;

---

[14] HR REP NO 108-548, pt. 1, at 343, 348 (2004).

[15] STAFF OF THE JOINT COMM. ON TAXATION, JCX-39-06, PRESENT LAW AND BACKGROUND RELATING TO EXECUTIVE COMPENSATION 2, 31 (2006) [hereinafter "***JCT 2006 Report***"].

[16] *See* IRS Notice 2005-1, 2005-1 CB 274 ("The Treasury Department and the Service are, however, concerned about arrangements purported to involve a substantial risk of forfeiture and fixed payment date where the parties do not intend for the substantial risk of forfeiture or fixed payment date to be enforced.").

[17] Application of Section 409A to Nonqualified Deferred Compensation Plans, 70 Fed Reg 57,930, 57,931 (proposed Oct 4, 2005) ("Among the many objectives underlying the enactment of section 409A is to limit the ability of a service provider to retain the benefits of the deferral of compensation while having excessive control over the timing of the ultimate payment.").

[18] N.Y. State Bar Ass'n Tax Section, *The New Nonqualified Deferred Compensation Regime: Comments on the Proposed Regulations*, 111 TAX NOTES 459 (2006).

[19] Doran, *supra* note 2, at 1311 ("A quarter century moratorium on rulemaking in the area prevented Treasury from narrowing the application of the constructive receipt doctrine for deferred compensation, and we saw the haircut legislation as a vehicle for setting boundaries around what was permissible." (footnote omitted)); *id.* (citing testimony of Pamela Olson, assistant Treasury secretary (tax policy) before the Senate Finance Committee, April 8, 2003).

- Disallow deferrals of gain on stock options and restricted stock; and
- Regulate common deferral techniques and limit participant control over payment timing.

¶ 600.3 Preliminary Notes

A. Certain Citations

In several instances, this Article cites to conversations with IRS officials that do not constitute formal guidance or authority; however, these citations are included because, in several cases, they constitute the sole available "authority" on the relevant points. This absence of actual authority highlights one of the key challenges to compensation planning in the era of IRC Section 409A and emphasizes the need for the IRS to provide clear and authoritative positions on these and other issues.

B. Moratorium on Rulings

There is currently a moratorium on most IRS rulings relating to IRC Section 409A[20] which exacerbates the problems caused by the absence of clear regulatory guidance, heightening the need for the proposed relief.

C. Exempt Payments and Deferred Compensation

Because of the broad scope of IRC Section 409A, most compensatory rights must comply with either the requirements applicable to "nonqualified deferred compensation" under IRC Section 409A or an exception to these requirements. For ease of reference, rights that constitute "nonqualified deferred compensation" under IRC Section 409A and thus must comply with the general requirements of IRC Section 409A are referred to below as "***Deferred Compensation***"; rights that satisfy an exception to the general requirements of IRC Section 409A are referred to as "***Exempt Payments***."

¶ 601 SHORT-TERM DEFERRAL EXCEPTION (STDE) AND VARIABLE VESTING DATES

IRC Section 409A characterizes any payment that will or may occur later than the end of the applicable 2 ½ month period following vesting as a "deferred payment" that is ineligible to qualify as an Exempt Payment under the STDE.[21] In the context of variable vesting date awards (*i.e.*, awards for which vesting occurs upon an event rather than a fixed calendar date), it is not clear under the final IRC Section 409A regulations (the "***Final Regulations***") whether this STDE requirement must be satisfied (i) from and after the time the legally binding right to the payment arises (*i.e.*, the grant or contract date), a time when the actual vesting date and the duration of the

---

[20] Rev Proc 2014-3, 2014-1 IRB 111.

[21] *See* Treas Reg § 1.409A-1(b)(4)(i)(D) (2007).

corresponding applicable 2 ½ month period may be unknown, or (ii) only later upon the actual date of vesting.

¶ 601.1 Overview of Relevant STDE Provisions

IRC Section 409A generally treats a payment as an Exempt Payment under the STDE (and thus not subject IRC Section 409A Penalties) if the payment is not a "deferred payment" and the service provider actually or constructively receives such payment on or before the last day of the applicable 2 ½ month period.[22]

A. Deferred Payments

A payment is a deferred payment if it is made pursuant to a provision of a plan that provides for the payment to be made or completed on or after any date, or upon or after the occurrence of any event, "that will or may occur later than the end of the applicable 2 ½ month period . . . regardless of whether an amount is actually paid as a result of the occurrence of such a payment date or event during the applicable 2 ½ month period."[23]

B. Applicable 2 ½ Month Period

The applicable 2 ½ month period is the period ending on the 15th day of the third month following the later to end of the service provider's first taxable year or the service recipient's first taxable year, in either case, in which the right to the payment is no longer subject to a "substantial risk of forfeiture" (referred to below as a "***Vesting Condition***")[24] (*i.e.*, the 15th day of the third month following the year in which the payment right vests).

¶ 601.2 Impact of Uncertainty Regarding Variable Vesting Dates

If the determination as to whether payments fall within the applicable 2 ½ month period must be made upon creation of a legally binding right to a payment with a variable vesting date (*e.g.*, involuntary separation pay which vests upon an unspecified termination date), any payment that may occur more than *2 ½ months* after vesting will fail to qualify as an Exempt Payment under the STDE. This outcome results from the possibility of late-year vesting that would shorten the applicable 2 ½ month period. For example, assume an employee is entitled to six months' salary continuation payments paid monthly following an involuntary termination and that both the employer and employee are calendar-year taxpayers—because the employee *could* be terminated in late December and therefore up to four of the salary continuation installments *might* occur after March 15th of the following year (the expiration of the applicable 2 ½

[22] *Id.* § 1.409A-1(b)(4)(i).

[23] *Id.* § 1.409A-1(b)(4)(i)(D) (emphasis added).

[24] *Id.* § 1.409A-1(b)(4)(i)(A).

month period), under a grant/contract-date assessment of the STDE, no more than two of the salary continuation installment payments could ever qualify for the STDE, even if the termination in fact occurs in February and all of the payments are made in the same year as the termination.

By contrast, determination as to whether payments fall within the applicable 2 ½ month period at the time of actual vesting would permit payments occurring within up to *14 ½ months* after vesting to qualify as Exempt Payments under the STDE (*i.e.*, due to the possibility of early-year vesting), while still limiting the benefit of the STDE to payments that are actually made within the applicable 2 ½ month period.

The lack of clarity around when to properly assess whether payments fall within the applicable 2 ½ month period causes uncertainty as to whether certain variable vesting date rights that are in fact paid within or shortly after the year of vesting (and thus within timing requirements historically excluding such payments from characterization as Deferred Compensation)[25] qualify as Exempt Payments under the STDE. As a result, certain rights that would in fact be payable within or shortly following the year of vesting and thus should qualify as Exempt Payments under the STDE (*e.g.*, in the example above, six monthly salary continuation payments following an involuntary termination in February) must either be paid on an accelerated basis upon vesting or be structured in accordance with the more restrictive requirements applicable to Deferred Compensation under IRC Section 409A (or another applicable exception).[26]

¶ 601.3 Discussion and Analysis

As discussed above, for purposes of applying the STDE, we must determine whether a payment "will or may" be paid within the applicable 2 ½ month period, but it is not clear whether this assessment may occur upon the vesting of the payment in question, or instead must be made earlier at the time the legally binding right arises (*i.e.*, the date on which the contract or grant is created). Because a payment that "may" be made outside the applicable 2 ½ month period constitutes a "deferred payment" that is ineligible for the STDE, any payment that *may* be made more than 2 ½ months after *any variable vesting date* will automatically be ineligible for the STDE based on a contract/grant date assessment.[27] For the following reasons, vesting date assessment is

---

[25] *See, e.g.,* Temp Treas Reg § 1.404(b)-1T, Q&A 2 (as amended in 1992); Treas Reg § 31.3121(v)(2)-1(b) (1999); *id.* § 31.3306(r)(2)-1(a) (1999).

[26] The uncertainty is amplified with respect to certain separation payments, in that separation payments which constitute Deferred Compensation may be subject to a mandatory six-month payment delay under IRC Section 409A, while STDE separation payments qualifying as Exempt Payments are not. *See* Treas Reg § 1.409A-3(i)(2). For a thorough discussion of the interplay between separation pay and the six-month delay rule, see Andrew L. Oringer, *Terminating the Six-Month Delay Rule for Severance Pay*, 116 TAX NOTES 189 (2007).

[27] For example, unless the payments satisfied the conditions of another exemption, this approach

the more appropriate approach under the STDE:

A. Support in Applicable Guidance

The preamble to the Final Regulations[28] (the "***Preamble to the Final Regulations***") acknowledges that the STDE rule is intended to apply to payments made shortly after (and, implicitly, during) a relevant tax year.[29] Consistent with this interpretation, determining whether payments fall within the applicable 2 ½ month period at the time of vesting ensures that all payments which are actually made during or within 2 ½ months after the applicable vesting year are properly characterized as Exempt Payments under the STDE. By contrast, making this assessment *prior to* the vesting of any variable vesting date right or award strictly limits the applicable 2 ½ month period to the minimum 2 ½ months (rather than up to 14 ½ months) for any amounts payable by reference to the lapsing of the applicable Vesting Condition.

This limitation results from the possibility that payments occurring more than 2 ½ months after vesting will fall outside the applicable 2 ½ month period if the variable vesting date occurs later in the year (*e.g.*, December 31). Thus, pre-vesting measurement of the applicable 2 ½ month period would have the incongruous result that even payments made in the *same year* as the vesting event (or shortly after) cannot qualify as Exempt Payments under the STDE if payable by their terms more than 2 ½ months after vesting. Only vesting-date measurement of the applicable 2 ½ month period ensures an outcome consistent with the purpose of the STDE identified in the Preamble to the Final Regulations.

B. IRC Section 409A Contains Exceptions to the STDE "Deferred Payment" Limitation for Payments That May Actually Occur Outside the Applicable 2 ½ Month Period

As discussed above, the applicable 2 ½ month period itself is measured from the lapsing of the Vesting Condition. However, IRC Section 409A allows for tolling the clock on the applicable 2 ½ month period after the lapse of an applicable Vesting Condition in certain situations (thus permitting payments that fall outside the would-be applicable 2 ½ month period to constitute Exempt Payments under the STDE), for example:

---

would cause at least a portion of salary continuation severance payments that extend only three months after an involuntary termination of employment to constitute Deferred Compensation that must be structured as compliant Deferred Compensation payments for purposes of IRC Section 409A, even if paid during a single calendar year.

[28] TD 9321, 2007-1 CB 1123.

[29] "The [STDE] rule is based on the historical treatment of certain payments paid within a short period following the end of a taxable year as not constituting deferred compensation." *Id.* at 1126.

1. Good Reason

If a Vesting Condition lapses upon "good reason" in the executive severance context, the applicable 2 ½ month period does not start until the executive's actual termination of employment, even though the forfeiture risk terminates (and the Vesting Condition thus lapses) upon the good reason event (or the later expiration of any applicable cure period).[30] Because the period prior to termination of employment, but following the actual lapsing of the Vesting Condition upon the good reason/non-cure event (which may last up to a year or more), can consume some or all of the applicable 2 ½ month period as measured from the true vesting of the payment, it is possible for good reason severance payments that fall well outside of the normally-applicable deadline to still qualify for the STDE.

2. Performance Conditions

Vesting Conditions are often comprised of performance goals, which may in fact be satisfied well in advance of the end of a performance period. Under the STDE rules, the applicable 2 ½ month period should in theory be measured from the date on which the performance goals are attained and the "substantial risk of forfeiture" that comprises the Vesting Condition lapses (assuming that no other Vesting Condition, such as continued employment, applies). However, practitioners commonly measure the applicable 2 ½ month period (and corresponding determinations of whether payments fall within such period) from the end of the performance period.[31]

In both the "good reason" and "performance vest" scenarios, a payment may actually occur after the expiration of the would-be applicable 2 ½ month period, as determined by reference to the actual lapsing of the Vesting Condition (rather than the termination of employment or the performance period, as applicable). Since these good reason and performance vest payments may occur outside of the true applicable 2 ½ month period and still qualify for the STDE, it is difficult to see why payments which actually must occur within the applicable 2 ½ month period based on a vesting-date assessment of the STDE should not also be afforded reliance on the STDE.

C. Complete Absence of Payment Timing Does Not Render the STDE Unavailable

IRC Section 409A explicitly permits payments under an agreement that is silent as

---

[30] *See id*. at 1137–38; IRS Notice 2007-78, 2007-2 CB 780.

[31] *See* REGINA OLSHAN & ERICA F. SCHOHN, SECTION 409A HANDBOOK 45 (2010) (concluding, based on an analogy to unspecified prior practices under Internal Revenue Code Sections 83 and 457, that "if a bonus award is made subject to achievement of a specified performance target over a three-year period and the performance target constitutes a substantial risk of forfeiture, the substantial risk of forfeiture remains until the target is reached or is waived, even if at some earlier point the achievement of the target becomes very likely").

to payment timing to qualify for the STDE, as long as the payments are actually made within the applicable 2 ½ month period.[32] An agreement that is silent as to payment timing in actuality provides by its terms for payment at any conceivable time (including, of course, potentially following the expiration of the applicable 2 ½ month period). Under such an arrangement, payment necessarily occurs on or after vesting and, as a result, there is no way to know until payment is made whether such payment will or may be paid after the applicable 2 ½ month period (because there are no limitations applicable to the payment timing).

Accordingly, in order to conclude that payments pursuant to an arrangement with unspecified payment timing qualify for the STDE (as expressly permitted by IRC Section 409A guidance), we must infer that the proper time to assess whether the payment will be made within the applicable 2 ½ month period is at the time of payment, which necessarily occurs upon (or even following) vesting for such payments. Prior to vesting, it will always be possible that the payments could be made after the applicable 2 ½ month period due to the absence of payment terms, so any earlier STDE assessment would disqualify all payments with unspecified timing from reliance on the STDE (because all such payments *might* be paid after the applicable 2 ½ month period).

Because vesting-date (or later) assessment of the STDE is available with respect to arrangements that say nothing at all as to payment timing (and thus make no apparent effort to comply with IRC Section 409A), there is no apparent rationale for denying this more favorable assessment timing with respect to agreements that actually contain a payment schedule and attempt to comply with, or satisfy an exception to, the complex IRC Section 409A regulatory framework.

D. STDE Application to Fixed and Variable Vesting Dates Should be Consistent

The STDE generally exempts from IRC Section 409A any payments that are actually or constructively received by the service provider within the applicable 2 ½ month period, drawing no distinction as to whether that period is determined by

---

[32] *See, e.g.*, TD 9321, 2007-1 CB at 1125 ("However, where a plan does not specify a payment date, payment event or term of years (or specifies a date or event certain to occur during the year in which the services are performed), the plan generally will not provide for the deferral of compensation if the service provider actually or constructively receives the payment within the short-term deferral period."); *id.* at 1127 ("Conversely, where a plan specifies no payment date or payment event . . . the plan may qualify for the short-term deferral rule if the payment is made within the applicable short-term deferral period."). See also Joint Comm. on Emp. Benefits, Am. Bar Ass'n Section of Taxation, May Meeting 2010, Q&A 29 (2010) [hereinafter "***JCEB May 2010 Meeting***"], *available at* http://www.americanbar.org/content/dam/aba/migrated/jceb/2010/2010IRSFINAL.authcheckdam.pdf, which reaches the same conclusion.

reference to a fixed or variable vesting date. However, if a determination as to whether a payment "will or may" be made within the applicable 2 ½ month period is made at the time of grant or entry into the applicable contract (or otherwise prior to vesting), the result is that payments pursuant to a variable vesting date award will automatically be excluded from the STDE if payable more than 2 ½ months after vesting, while payments pursuant to a fixed vesting date award may be payable up to 14 ½ months after vesting and still qualify for the STDE. IRC Section 409A provides no basis for this distinction between fixed-date and variable-date vesting arrangements, and there is no apparent reason to infer such a distinction.

E. Consistency With Determination Timing for Applicable 2 ½ Month Period

The Final Regulations specify that the actual applicable 2 ½ month period is measured at the time of vesting (*e.g.*, termination of employment).[33] By contrast, the Final Regulations do not offer any guidance as to the time at which the determination as to whether payments fall within the applicable 2 ½ month period should be made. In the absence of guidance, there is no apparent rationale for a different approach to these two related measurements. For consistency, determinations as to whether payments fall within the applicable 2 ½ month period should be made at the time of vesting.

¶ 601.4 Significant Conflicts in Available Guidance

The published IRC Section 409A guidance does not resolve the existing ambiguity as to whether payment timing assessment under the STDE is to be made at the time the legally binding right arises (*i.e.*, a grant/contract date assessment) or at the time the Vesting Condition lapses (*i.e.*, upon termination of employment or other vesting). Unfortunately, this ambiguity has been further exacerbated through unofficial guidance that has become available over the years since the enactment of IRC Section 409A—this unofficial guidance seems to contradict itself in several instances, further clouding the water. Following are the key examples:

A. Unofficial Guidance Suggesting Payment Timing Must Be Assessed as of the Grant/Contract Date (*i.e.*, Payment Cannot Be Later Than 2 ½ Months From Vesting for Any Variable Vesting Date Compensation)

1. IRS Releases

- "[A] deferral of compensation does not occur if, absent an election to otherwise defer the payment to a later period, *at all times the terms of the plan require payment by*, and an amount is actually or constructively" paid within

[33] *See* Treas Reg § 1.409A-1(b)(4)(i)(A) (2007).

the applicable 2 ½ month period.[34]

- "Although a plan need not specify a payment date to be a short-term deferral that is excluded from coverage under IRC Section 409A, the short-term deferral exclusion does not apply if the payment event or date is specified and will or may occur after the end of the short-term deferral period."[35]

2. IRS Response to Questions Posed at Meeting of the JCEB

A severance arrangement provides, among other things, for payment upon a change in control occurring 120 days after an involuntary termination of employment. Because the payment *may occur* as much as 120 days after the involuntary termination (the lapse of the Vesting Condition in the example), the IRS believes that the payment is ineligible for the STDE, whether or not actually paid within the STDE.[36]

3. IRS Representatives at Conferences and Webcasts

- If a promise provides for the "potentiality of deferral" then it is "deferred compensation" (and the STDE is unavailable).[37]
- "If a legally binding right provides for the possibility of deferral beyond the time that a short-term contingency is met, that legally binding promise would provide for deferral because it provides for the possibility of deferral."[38]

B. Guidance Suggesting Payment Timing May Be Assessed as of the Vesting Date (*i.e.*, Maximum Payment up to 14 ½ Months From Vesting for Any Compensation)

1. IRS Responses to Questions Posed at Meetings of the JCEB

- With regard to a June 30 involuntary termination from a company with a

---

[34] IRS Notice 2005-1, § IV.A, Q&A 4(c), 2005-1 CB 274, 277–78 (emphasis added). This guidance was subsequently superseded, but it is consistent with the Preamble to the Final Regulations, *see* TD 9321, 2007-1 CB at 1126, and remains indicative of the uncertainty surrounding interpretation of the applicability of the STDE with respect to variable vesting date awards. See also Jack S. Levin, Keith E. Villmow & Donald E. Rocap, *The Jobs Act's Harsh New Deferred Compensation Rules*, 108 TAX NOTES 1269, 1279–80 (2005), for commentary adopting a similar interpretation of this rule.

[35] TD 9321, 2007-1 CB at 1127.

[36] JOINT COMM. ON EMP. BENEFITS, AM. BAR ASS'N SECTION OF TAXATION, MAY MEETING 2009, Q&A 31 (2009) [hereinafter "***JCEB May 2009 Meeting***"], *available at* http://www.americanbar.org/content/dam/aba/migrated/jceb/2009/IRS2009.authcheckdam.pdf.

[37] Daniel Hogans, Attorney Advisor, Office of Benefits Tax Counsel, U.S. Treasury Dep't, Final Code § 409A Regulations: A "Nuts and Bolts" Approach, American Society of Pension Professionals & Actuaries Webcast (June 4, 2007).

[38] Daniel Hogans, Attorney Advisor, Office of Benefits Tax Counsel, U.S. Treasury Dep't, PricewaterhouseCoopers Webcast (Apr 18, 2007).

calendar fiscal year, up to 9 monthly salary continuation installments payable on the 15th day of the month may be taken into account in determining the portion of the severance for which STDE is available[39] (rather than just three if the assessment was made on the date the legally binding right arose).

- In connection with an involuntary termination of employment occurring in January, salary continuation payments that are payable through March 15th of the following year (*i.e.*, over fourteen months) are eligible for the STDE.[40]

2. IRS Representatives at Conferences and Webcasts

Regarding the determination of the short-term deferral period, "we first determine the short-term period . . . based on what actually happened *when you vested*; next is what payments are or could be outside that period."[41]

¶ 601.5 Assessment of Key Policy Goals Applicable to the STDE

The Key Policy Goals implicated by the STDE are (1) legitimate Vesting Conditions; (2) undue control over payment timing; and (3) other abusive deferral practices. Measuring the applicable 2 ½ month period upon the vesting date does not offend any of these Key Policy Goals. First, the legitimacy of the Vesting Condition is not in question; the proposal for vesting-date determinations as to whether payments fall within the applicable 2 ½ month period is only intended to reach payment rights that are subject to legitimate Vesting Conditions in the first place. In addition, because the payments in question could only be made by reference to a legitimate Vesting Condition, the satisfaction of which is implicitly beyond the discretion of the service provider, no material potential for undue control or other abuse arises in connection with this measurement timing.

¶ 601.6 Practical Application and Best Practices Under Current Law

A. Assess Payments Upon Grant/Contract Date

In the absence of clear guidance supporting vesting-date determinations as to whether payments will be made within the applicable 2 ½ month period, the best

---

[39] *See* JCEB May 2010 Meeting, *supra* note 32, Q&A 31A (requiring, however, that the payments be designated as separate payments). Note that this JCEB is the most recent of the unofficial guidance, suggesting that the current IRS thinking favors the vesting-date STDE assessment proposed here.

[40] Joint Comm. on Emp. Benefits, Am. Bar Ass'n Section of Taxation, May Meeting 2013, Q&A 19 (2013) [hereinafter "***JCEB May 2013 Meeting***"], *available at* http://www.americanbar.org/content/dam/aba/events/employee_benefits/2013_irs_qa.authcheckdam.pdf.

[41] Stephen Tackney, Senior Counsel, Office of Chief Counsel, Internal Revenue Serv., ALI-ABA Webcast: Section 409A Compliance and Proxy Statements: Drafting Challenges (Feb. 4, 2008) (emphasis added), *reported in* Mary Hughes, *Section 409A Questions Are Answered, with Caveats and Cautions, by Tax Attorneys*, Pension & Benefits Daily, Feb 6, 2008, *available at* 24 PBD, 2/6/08.

practice is to make this assessment upon the grant or contract date and ensure that any payments which may be made more than 2 ½ months after the Vesting Condition lapses otherwise qualify as either Exempt Payments or compliant Deferred Compensation. In light of the severity of IRC Section 409A Penalties and the significant contradictions in available guidance, many practitioners believe that it is too risky to depend on the availability of the STDE with respect to payments that might be made after the applicable 2 ½ month period (based on a grant/contract date assessment).[42]

B. Separate Payments

It is also important to designate all installment payments (*e.g.*, post-termination salary continuation payments) as "separate payments" for purposes of IRC Section 409A, as this designation is required under IRC Section 409A to permit assessment of each installment separately for purposes of applying the STDE. For example, if salary continuation payments will be paid as severance upon an involuntary termination for one year following termination, designating the installments as "separate payments" will ensure that all payments which must be made by their terms within the first 2 ½ months following termination qualify for the STDE. Without this designation, the entire payment stream will be viewed as a single payment for IRC Section 409A purposes and no portion of the payments will qualify for the STDE.[43]

¶ 601.7 Proposed Relief

The IRS should clarify in official guidance that taxpayers may assess whether payments fall within the applicable 2 ½ month period upon the applicable vesting date rather than upon the date the legally binding obligation arises for purposes of the STDE.[44] This clarification is consistent with the trend in recent (though unofficial) guidance[45] and will have no impact on the policy goals relevant to the STDE (*i.e.*, illusory Vesting Conditions and undue control over payment timing). This clarification is also consistent with the historical tax practice of excluding amounts payable during or shortly after the vesting year from the scope of deferred compensation.[46] Finally,

---

[42] That said, it seems reasonable to take the position (after the fact) that the STDE is available with respect to payments that are in fact made during the applicable 2 ½ month period following vesting as an argument to avoid the application of IRC Section 409A Penalties.

[43] *See* Treas Reg §§ 1.409A-1(b)(4)(i)(F), -2(b)(2)(iii) (2007).

[44] Even more helpful (though perhaps less likely) would be an expansion of the STDE to permit payments by the end of the calendar year following that in which the Vesting Condition lapses, rather than limiting such payments to the applicable 2 ½ month period following such year. Since the STDE already permits payments that may span two calendar years, it is not clear what policy goal is served by limiting payments in the latter such year to this arbitrary deadline.

[45] *See*, *e.g.*, JCEB May 2013 Meeting, *supra* note 40, Q&A 19.

[46] *See, e.g.*, Temp Treas Reg § 1.404(b)-1T, Q&A 2 (as amended in 1992); Treas Reg

this clarification will validate non-abusive practices that already exist in parts of the market[47] and greatly reduce uncertainty for taxpayers, two improvements that are desperately needed in the area of IRC Section 409A.

¶ 602 POST-TRANSACTION CASH-OUTS OF STOCK OPTIONS AND STOCK APPRECIATION RIGHTS

In the context of corporate merger and acquisition transactions ("***Transactions***"), with respect to stock options and SARs, it is not clear (i) whether companies may pay out an award's "***Spread***" (*i.e.*, the excess of the per share transaction price over the stock option's or SAR's exercise or strike price, as applicable) on the post-closing vesting dates that would have applied to the underlying award in the absence of a Transaction (a "***Vesting-Date Payout***"), or (ii) whether a Vesting-Date Payout will constitute an impermissible option or SAR "extension" that will result in IRC Section 409A Penalties. Vesting-Date Payouts have historically served as a valid, non-abusive component of compensation planning in the context of Transactions, intended to preserve existing retention incentives and avoid potential windfalls to employees and other service providers (referred to collectively as "***Employees***"), but their permissibility under IRC Section 409A remains unclear, creating significant risk and uncertainty around the treatment of equity compensation awards in Transactions.

¶ 602.1 Overview of Applicable Regulatory Provision

Typical stock options and SARs contain a variable exercise date feature which effectively permits Employees to exercise and thus choose their year of taxation over an extended period of years.[48] This discretion would result in IRC Section 409A Penalties with respect to most other forms of compensation, but the drafters of IRC Section 409A seemingly recognized the utility of these awards[49] and included special exceptions in order to preserve their viability under IRC Section 409A. In order to qualify as Exempt Payments under these exceptions, the stock options and SARs must

---

§ 31.3121(v)(2)-1(b) (1999); *id*. § 31.3306(r)(2)-1(a) (1999).

[47] The *Section 409A Handbook* notes that "it is generally accepted that any severance benefits that are, in fact, paid prior to March 15 of the year following the year in which the service provider's involuntary separation occurred will qualify as short-term deferrals." OLSHAN & SCHOHN, *supra* note 31, at 168. While, in this author's experience, practitioners have generally been more conservative and have not relied on this vesting date analysis of STDE payments, there is no question that this practice exists in the marketplace.

[48] As discussed below, the exercise of an incentive stock option ordinarily is not a tax event (by contrast to nonqualified stock options and SARs); however, holders of incentive stock options have similarly broad latitude to control the tax timing applicable to these awards.

[49] *See, e.g.*, HR REP NO 108-755, at 735 (2004) (Conf Rep) (noting that IRC Section 409A was not intended to change the tax treatment of most stock options governed by Internal Revenue Code Sections 83 or 422 and 423).

meet certain conditions, as detailed below.

A. Applicable IRC Section 409A Exceptions

1. Nonqualified Stock Options

A nonqualified stock option generally does not provide for a deferral of compensation (and thus constitutes an Exempt Payment) if, among other things, (i) the exercise price of the stock option may never be less than the fair market value of the underlying stock on the applicable stock option grant date, (ii) the stock option is subject to taxation under Internal Revenue Code Section 83, and (iii) the stock option does not include "any feature for the deferral of compensation" other than the deferral of recognition of income until the later of the exercise of the stock option or the vesting of the shares underlying the exercised stock option (the "***NSO Exception***").[50]

2. Stock Appreciation Rights

A SAR generally does not provide for a deferral of compensation (and thus constitutes an Exempt Payment) if, among other things, (i) compensation payable under the SAR cannot exceed the applicable Spread based on a fixed number of shares subject to the SAR that is determined on the applicable grant date, (ii) the strike price of the SAR may never be less than the fair market value of the underlying stock on the applicable SAR grant date, and (iii) the SAR does not include "any feature for the deferral of compensation" other than the deferral of recognition of income until the exercise of the SAR (the "***SAR Exception***").[51]

3. Incentive Stock Options

Incentive stock options that meet the requirements for tax qualification under Internal Revenue Code Sections 421–424 generally do not provide for a deferral of compensation (and thus constitute Exempt Payments)[52] (the "***ISO Exception***" and, together with the NSO Exception and the SAR Exception, the "***Stock Right Exceptions***").

B. Extensions[53]

1. Definition of Extension

"An extension of a stock right refers to the provision to the holder of an additional

---

[50] Treas Reg § 1.409A-1(b)(5)(i)(A) (2007). The NSO Exception contains additional requirements that are not relevant to this discussion.

[51] *Id.* § 1.409A-1(b)(5)(i)(B). The SAR Exception contains additional requirements that are not relevant to this discussion.

[52] *Id.* § 1.409A-1(b)(5)(ii).

[53] Under IRC Section 409A, changes to stock options and SARs may also constitute "modifications"

period of time within which to exercise the stock right beyond the time originally prescribed under the terms of the stock right, *the conversion or exchange of a stock right for a legally binding right to compensation in a future taxable year*, or the addition of any feature for the deferral of compensation not permitted [under the applicable Stock Right Exception] . . . ."[54]

2. Impact of Extensions

If there is an "extension" of a stock option or SAR, the award is treated as having had an additional deferral feature from the original date of grant and is therefore treated as a plan providing for the deferral of compensation from its original grant date.[55] In the context of a typical stock option or SAR with a multi-year exercise window, this treatment will generally result in IRC Section 409A Penalties and interest applied in the year of vesting[56] (*i.e.*, under our facts, in the year of the post-closing Vesting-Date Payouts).

¶ 602.2 Current Impact of Issue

A. Prior Practice

Prior to the enactment of IRC Section 409A, it was a relatively common practice in the context of Transactions for buyers to provide that stock options or SARs issued by the target company to its Employees would only receive payments with respect to their unvested stock options or SARs if the Employees remained employed or in service to the surviving company (or its affiliates) through the post-closing vesting date(s) applicable to the underlying award (*i.e.*, a Vesting-Date Payout).[57]

---

if the change to the terms of the stock option or SAR may provide the holder of the award with a direct or indirect reduction in the exercise price of the award (regardless of whether the holder in fact benefits from the change in terms). *See* Treas Reg § 1.409A-1(b)(5)(v)(B). Because Vesting-Date Payouts do not affect the exercise price of the stock option or SAR and thus should not constitute "modifications," a discussion of modifications is beyond the scope of this Article.

[54] Treas Reg § 1.409A-1(b)(5)(v)(C)(1) (emphasis added). The definition of "extension" also provides certain exceptions for "underwater" stock options and SARs, as well as for tolling expiration where exercise of the right would violate applicable law—none of these exceptions are relevant to this discussion. *See generally id.*

[55] Treas Reg § 1.409A-1(b)(5)(v)(A). Note that this fictional look-back to the year of grant for purposes of applying IRC Section 409A Penalties can be even more punitive than ordinary IRC Section 409A Penalties, which generally assess penalties only from the actual year of violation (or, if later, the year of vesting). IRC § 409A(a)(1)(B) (2006).

[56] *See* Prop Treas Reg § 1.409A-4(d), 73 Fed Reg 74,380, 74,399–402 (Dec 8, 2008).

[57] This practice also continued during the first few years following enactment of IRC Section 409A under transition guidance which made the practice permissible under certain circumstances. *See, e.g.*, IRS Notice 2008-113, §§ IV.D, V.E, 2008-2 CB 1305, 1311, 1314; IRS Notice 2007-100, § II.E, 2007-2 CB

B. Current Market Uncertainty

While unclear, the term "extensions" (as defined in IRC Section 409A) could be read to apply to Vesting-Date Payouts (and may thus result in substantial IRC Section 409A Penalties) if the right to payment under the Vesting-Date Payout was deemed to constitute an exchange of a stock right for a legally binding right to compensation in a future taxable year. As a result of this uncertainty, many companies refrain from Vesting-Date Payouts and instead either accelerate and pay out unvested stock options and SARs at closing (which may provide windfalls to Employees) or enter into cumbersome and inefficient alternative arrangements.

¶ 602.3 Discussion and Analysis

Vesting-Date Payouts are an important component of many Transactions that permit parties to continue to benefit from the existing retention incentive inherent in an unvested stock option or SAR and to thus avoid providing potential windfalls to target company Employees. Vesting-Date Payouts provide for payment on the first date on which the stock option or SAR would have been payable (*i.e.*, exercisable) in the absence of the Transaction, and therefore provide no deferral beyond that contained in the underlying stock option or SAR. Because Vesting-Date Payouts are negotiated between companies at arms-length, there is little or no potential abuse of this arrangement by Employees. While the applicable regulatory language creates some ambiguity as to whether a Vesting-Date Payout may constitute an "extension" of a stock option or SAR, for the following reasons, it is implausible to construe Vesting-Date Payouts in this manner.

A. Plain Meaning of the Term Extension

The date of exercise generally constitutes the "payment date" with respect to a stock option or SAR[58] because that is the date on which the applicable payment is actually received for tax purposes.[59] Vesting-Date Payouts provide Employees with payments on the earliest possible payment date(s) applicable under the terms of the underlying stock option or SAR (*i.e.*, the first date on which the award would be exercisable and thus taxable). Though only limited guidance is available interpreting the term

---

1243, 1247-48; IRS Notice 2007-86, § 3.01(B)(1), 2007-2 CB 990, 992; IRS Notice 2006-79, § 3.04, 2006-2 CB 763, 764–65.

[58] Note that, by contrast to nonqualified stock options, incentive stock options generally are not taxable upon exercise under Internal Revenue Code Section 421, but are instead taxable upon the disposition of their underlying shares. However, because a Vesting-Date Payout involves an immediate disposition of the underlying shares upon the applicable vesting (and hypothetical exercise) date, the tax event for incentive stock options under these facts is the same as it is for nonqualified stock options and SARs, and is so grouped in this discussion accordingly.

[59] *See generally* IRC §§ 61, 83.

"extension" for stock options and SARs under IRC Section 409A, it appears that regulators contemplated the common sense meaning of "granting an additional period in which to exercise the award."[60] Under this interpretation, it is implausible to conclude that a Vesting-Date Payout constitutes an extension—instead, the payment is made on the first permissible exercise (payment) date under the award.

B. Mere Change In Medium

IRC Section 409A regulates the timing of deferrals and payments (and changes thereto), but broadly permits changes in medium of payment that do not impact timing.[61] In the case of a Vesting-Date Payout, cash or other purchase consideration is substituted for the granting company's equity, thus changing the medium of payment.[62] However, the payment timing of the award is not affected by this change in medium—as discussed above, payment is still made on the earliest payment date permitted under the terms of the award.[63] Accordingly, since Vesting-Date Payouts are in effect just changes in medium (that do not effectively change payment timing), such arrangements should not constitute "extensions" and should therefore be permissible in accordance with IRC Section 409A.

---

[60] *See, e.g.*, Application of Section 409A to Nonqualified Deferred Compensation Plans, 70 Fed Reg 57,930, 57,936 (proposed Oct 4, 2005) ("Generally, an extension granting the holder *an additional period within which to exercise the stock right beyond the time originally prescribed* will be treated as evidencing an additional deferral feature . . . ." (emphasis added)); TD 9321, 2007-1 CB 1123, 1132–33 ("The final regulations generally retain the rules in the proposed regulations that generally treat *extensions of the exercise period of a stock right* as an additional deferral feature as of the date of grant of the right . . . . Accordingly, if an arrangement provides for a potential to defer the payment of cash or property upon the exercise or exchange of a stock right *beyond the year the right is exercised* or beyond the original term of the stock right, the arrangement provides for a deferral feature . . . ." (emphases added)).

[61] *See, e.g.,* HR Rep No 108-755, at 731 (2004) (Conf Rep) ("However, it is intended that the rule against accelerations is not violated merely because a plan provides a choice between cash and taxable property if the timing and amount of income inclusion is the same regardless of the medium of distribution."); TD 9321, 2007-1 CB at 1132 ("The application of section 409A generally is not affected by the medium of a taxable payment (for example, cash or stock.").

[62] Note that SARs may be "cash-settled" by their terms, in which case there may not even be a change in medium in the context of a Vesting-Date Payout; however, neither the presence nor the absence of a change in medium should constitute an "extension."

[63] Note that, in the context of Transactions, IRC Section 409A actually permits certain additional payment deferrals, including, for example, with respect to certain "transaction-based compensation," Treas Reg § 1.409A-3(i)(5)(iv)(A) (2007), and/or certain "nonvested compensation," *id.* § 1.409A-3(i)(5)(iv)(B). While use of these additional deferral provisions should be permitted in certain contexts in conjunction with a Vesting-Date Payout (and the non-vested compensation exception is discussed below), an analysis of the general interplay of these provisions is beyond the scope of this discussion, which is limited to payment on the initial vesting date provided in the underlying award.

C. Early Exercise Yields Same Permissible Result

Stock options and stock-settled SARs often permit Employees to "early exercise" these awards,[64] meaning that the Employee exercises the stock option or stock-settled SAR prior to vesting and receives restricted stock that vests on the schedule applicable to the early exercised award (rather than vested shares). An early exercise generally does not accelerate the time of income inclusion due to the application of the original vesting schedule to the resulting restricted shares. As discussed below, it is relatively clear that IRC Section 409A permits the payout of Transaction consideration to restricted stockholders on post-closing vesting dates (*i.e.,* a Vesting-Date Payout for restricted stock).

1. Restricted Stock Generally

In the context of restricted stock, IRC Section 409A provides that "there is no deferral of compensation merely because the value of the property is not includible in income by reason of the property being substantially nonvested."[65] In addition, "extension" restrictions do not apply to restricted stock, as these restrictions are contained in, and implicitly limited to, provisions governing stock options and SARs.[66] Accordingly, there is no basis for prohibiting payout in cash (or any other medium of Transaction consideration payable in respect of restricted shares) on post-closing vesting dates applicable to the underlying restricted stock award. Practitioners commonly take the position that such post-Transaction cash payouts represent a mere change in medium that is permitted by IRC Section 409A.

2. Early Exercise Restricted Shares

Because restricted stock can be paid out in cash on post-Transaction vesting dates, a two-step transaction which yields the same result (*i.e.,* (i) stock options or stock-settled SARs are exercised early into restricted stock, and (ii) the closing date value of such restricted stock is then paid in cash on post-Transaction vesting dates) should likewise not violate IRC Section 409A.[67] However, requiring two steps to reach

---

[64] Even if an award does not contain "early exercise" provisions, it is a relatively simple matter to add them after the fact (though doing so may cause the disqualification of incentive stock options under Treas Reg § 1.424-1(e)).

[65] *Id.* § 1.409A-1(b)(6)(i). *See also* Application of Section 409A to Nonqualified Deferred Compensation Plans, 70 Fed Reg at 57,956 ("As a transfer of property subject to section 83 that becomes substantially vested after the year of substitution, [a grant of restricted stock] would not be subject to section 409A.").

[66] *See* Treas Reg § 1.409A-1(b)(5).

[67] IRS representatives have indicated in telephone conversations that restricted shares originating from the exercise of a stock option or SAR are tainted by such origination and thus ineligible for the "restricted property" exception contained in Treas Reg § 1.409A-1(b)(6) (on which the permissibility of Vesting-

this result creates administrative inconvenience with no benefit to any party—instead, the direct Vesting-Date Payout of stock options and SARs should be permissible.

D. "Future Taxable Year" Refers to Payment Year

IRC Section 409A defines "extension" in relevant part as the conversion or exchange of a stock option or SAR for a new right to compensation in a "future taxable year"—it is not clear from this language whether the relevant reference point for determining a "future year" is the year in which the change constituting the would-be "extension" occurs, or instead the actual year in which payment would occur absent such change. In keeping with IRC Section 409A policy goals of eliminating abusive deferral practices generally and limiting impermissible re-deferrals of stock options and SARs specifically,[68] the "future taxable year" should be determined by reference to the original payment year rather than the year of the change because a re-deferral can only occur by reference to such original payment year (*i.e.*, an amount cannot plausibly be considered "re-deferred" if it is paid on its original payment date, even if the medium of payment was altered in a prior year). Accordingly, a Vesting-Date Payout should not constitute an "extension" because it does not create a right to payment in a future taxable year (or otherwise implicate the "extension" definition).

E. Substitution of Exempt Payments is Generally Permissible and Vesting-Date Payouts Qualify Under the STDE

IRC Section 409A treats the payment of an amount that constitutes a substitute for the payment of Deferred Compensation as a payment of the original Deferred Compensation,[69] with the result that a change in the payment timing under the substituted amount from that applicable to the original Deferred Compensation may violate IRC Section 409A as an impermissible payment acceleration or deferral. By contrast, IRC Section 409A does not contain general substitution restrictions applicable to Exempt Payments (including stock options and SARs that qualify as Exempt Payments).[70] Accordingly, Exempt Payments that qualify for one IRC Section 409A

Date Payouts for restricted stock are premised). There is no apparent basis for this position distinguishing between types of restricted stock in any published IRC Section 409A guidance.

[68] *See supra* ¶ 600.2. Note that IRC Section 409A is equally concerned with impermissible payment accelerations, *see, e.g.*, Treas Reg § 1.409A-3(j) (prohibiting various payment timing accelerations); however, Vesting-Date Payouts involve payments upon (and not in advance of) payment dates identified in the original award. Accordingly, a discussion of impermissible payment accelerations is beyond the scope of this analysis. Perhaps ironically, it is relatively clear that an accelerated payout of a stock option or SAR on the Transaction closing date would be permissible, while the same cannot be said with regard to a Vesting-Date Payout which instead provides for payment on an actual payment date contemplated by the award.

[69] Treas Reg § 1.409A-3(f).

[70] Note that IRC Section 409A does contain detailed provisions controlling the substitution of an

exception are commonly replaced with different Exempt Payments that qualify for a different exception and which may be payable on varied payment schedules.[71] Note, however, that as an important exception to this interchangeability of Exempt Payments, IRC Section 409A disregards the extension of a Vesting Condition with respect to any STDE Exempt Payment and that, accordingly, extending a Vesting Condition directly or replacing one STDE payment with another that functions to extend the Vesting Condition can result in a IRC Section 409A violation.[72]

In the case of a Vesting-Date Payout, cash payments made on the post-closing vesting dates are generally subject to the same continued service requirement that applied to the underlying stock option or SAR and thus, if analyzed apart from the underlying stock option or SAR, should qualify for the STDE. In light of the permissibility of substituting Exempt Payments for one another generally and the fact that a Vesting-Date Payout does not result in the potentially impermissible extension of a Vesting Condition[73] (or any other conceivable re-deferral), Vesting-Date Payouts should constitute permissible STDE Exempt Payments that are not subject to IRC Section 409A Penalties.

F. Transaction Payments May Permissibly Be Re-Subjected to Vesting

In the context of Transactions, IRC Section 409A provides an important exception to its general prohibition on extending Vesting Conditions[74]—the exception permits

---

acquirer stock right for an existing stock option or SAR in a Transaction, *see* Treas Reg § 1.409A-1(b)(5)(iii)(E)(4), but these substitution provisions do not apply to the change of medium within the existing stock right that is contemplated by a Vesting-Date Payout and are therefore not relevant to this discussion.

[71] IRC Section 409A even provides in certain circumstances that exceptions applicable to Exempt Payments may be relied upon in conjunction with one another with respect to the various components of a payment or series of payments. For example, in the "separation pay" context, IRC Section 409A explicitly provides that the various separation pay exceptions may be used in combination with one another. TD 9321, 2007-1 CB 1123, 1136. It is also common for these exceptions to be combined with the STDE for the same purpose. Due to the fungible nature of money, permitted reliance on these exceptions in combination further supports the proposition that the exceptions may be substituted for one another in certain circumstances as well. See also *id.* at 1133, indicating that a choice between two Exempt Payments will not cause either amount to be deferred compensation subject to IRC Section 409A even if, considered together, the two amounts would constitute deferred compensation:

> Generally an election between compensation alternatives, none of which provides for a deferral of compensation within the meaning of section 409A, will not cause the election to be subject to the section 409A timing restrictions. Thus, a choice between an award of restricted stock or stock options that are not subject to section 409A will not be governed by the section 409A election timing rules.

[72] Treas Reg § 1.409A-1(d)(1).

[73] Vesting-Date Payouts would pay the spread upon (or perhaps shortly after) the original, initial vesting date.

[74] *See supra* ¶ 602.3.E.

the extension of a Vesting Condition or the creation of a new Vesting Condition with respect to a payment for which the existing Vesting Condition would lapse upon the Transaction (the "***Vesting Condition Extension Provision***").[75]

In the context of a Vesting-Date Payout, the applicable Vesting Condition would not lapse upon the Transaction, but would instead continue in effect until the originally-scheduled vesting date (subject to continued service). However, a common alternative to Vesting-Date Payouts (in the absence of clear guidance supporting this practice) is to cash-out unvested stock options and SARs upon the consummation of the Transaction, in which case the awards would in fact vest upon the Transaction. As a result, the Vesting Condition Extension Provision should be available, meaning that amounts payable upon the closing of the Transaction (*i.e.*, the accelerated Spread) could instead be paid on a later vesting date, including the original vesting date(s) underlying the options and SARs in question.[76] As with early-exercise stock options and SARs, no policy goal is served by requiring a two-step process and, accordingly, the direct Vesting-Date Payout of stock options and SARs should be permissible.

¶ 602.4 Absence of Published Guidance

Though the better interpretation of the "extension" definition under IRC Section 409A would exclude Vesting-Date Payouts, the language in this definition is unclear and may in fact be interpreted to apply to Vesting-Date Payouts. There does not appear to be any published guidance discussing the proper interpretation of this provision but, as with the STDE, the IRS has provided some unofficial guidance that is inconsistent, and which may not be relied upon as authority in any event. Following are the key examples:

A. Conversations with IRS Officials

In multiple phone conversations spanning a period of years, various IRS officials have voiced contradictory views as to whether a Vesting-Date Payout would constitute an "extension" of the stock option or SAR.[77] Certain IRS officials have further stated that, although the "extension" rules are relevant only to stock options and SARs, these rules would also reach restricted stock obtained upon the "early exercise" of such an award with the same tax result, thus invalidating the potential "early exercise" solution

---

[75] Treas Reg § 1.409A-3(i)(5)(iv)(B). The Vesting Condition Extension Provision is only available with respect to Transactions that constitute "change in control events" within the meaning of IRC Section 409A. This Section assumes that the Transactions assessed would so qualify.

[76] Under these circumstances, the Vesting Condition Extension Provision should permit us to impose vesting conditions that continue through alternative (and potentially later) post-Transaction dates as well.

[77] These phone conversations involved the author, certain colleagues of the author and IRS representatives. The author is not aware of any published guidance on point.

discussed above.[78]

B. Public Comments by IRS Officials

Treasury officials have indicated a willingness to reconsider the issue and permit payment on post-closing vesting dates, acknowledging that this practice "probably doesn't pose significant risks of abuse."[79]

¶ 602.5 Key Policy Considerations Around Extensions

The Key Policy Goals implicated by Vesting-Date Payouts are (1) the disallowance of deferrals or re-deferrals on stock option (and SAR) gains[80] and (2) the curtailment of abusive deferral practices. In addition, with reference to stock options, the IRS expressed specific concerns that stock options (and SARs) not be combined with put and call rights that could circumvent the purpose of IRC Section 409A.[81] In the context of a Vesting-Date Payout, stock options and SARs are taxed on the very first date on which these awards would have been taxable by their terms (*i.e.*, the vesting date is generally the first possible exercise/tax date for these awards) and, accordingly, there is no deferral or re-deferral of any taxable gain beyond that provided under the original award. In addition, Employees normally have no control over a Vesting-Date Payout, which is generally imposed at the behest of the buyer, meaning that there is little or no potential for Employees to engage in any abusive deferral practices. Finally, put/call rights are not implicated by a Vesting-Date Payout.

---

[78] As noted above, compensatory property transfers are generally exempt from IRC Section 409A under Treas Reg § 1.409A-1(b)(6) and there is no indication in the IRC Section 409A regulations or other published guidance or legislative history that stock right "extensions" can or should apply to such property. Nevertheless, certain IRS officials have indicated verbally an inclination to deem "extensions" applicable to property such as restricted stock obtained through a stock option or SAR exercise. Absent this deemed application of "extensions" to property obtained upon stock option or SAR exercise, it is relatively clear that payment in cash upon post-closing vesting dates in lieu of vesting restricted property on such dates would not cause such amounts to constitute Deferred Compensation. *See, e.g.*, sources cited *supra* note 61.

[79] Amy S. Elliott, *Treasury Addresses Change-in-Control Stock Option Cash-Out Provisions*, TAX NOTES TODAY, Oct 11, 2012, *available at* 2012 TNT 197-3 (summarizing speech by Robert Neis, acting Treasury deputy benefits tax counsel, speaking at a Practising Law Institute conference on October 10, 2012). In a *Tax Notes* article dated November 19, 2012, another IRS representative indicated that a Revenue Ruling on this topic would be forthcoming, but to date, no such ruling has been issued. *See* Shamik Trivedi, *Healthcare Provider Deduction Limits Next on Treasury's List*, 137 TAX NOTES 865, 866 (2012).

[80] In addition the general re-deferral concerns identified in the Introduction above, a principal concern identified with regard to equity awards specifically in the context of the Enron investigation was the ability of Employees to defer tax in connection with an option exercise. *See* JCT Enron Report, *supra* note 6, at 631–33.

[81] IRS Notice 2005-1, § I.B, 2005-1 CB 274, 275.

¶ 602.6 Practical Application and Best Practices Under Current Law

Some companies engage in Vesting-Date Payouts under current guidance, particularly in the area of internet and technology transactions. However, it is risky to do so under the definition of "extension" contained in IRC Section 409A in the absence of guidance clarifying the non-application of this definition to Vesting-Date Payouts. This is particularly so in light of numerous verbal indications from IRS representatives that this practice is not permitted and may result in IRC Section 409A Penalties. Accordingly, pending further published guidance, companies should consider alternatives to Vesting-Date Payouts, including closing-date payout of the awards or substitution of new stock rights in accordance with IRC Section 409A.

¶ 602.7 Proposed Relief

Vesting-Date Payouts are a legitimate, historical business practice with respect to stock options and SARs that do not involve any disguised or abusive deferral tactics.[82] Holders of unvested stock options and SARs generally have no control or influence over a company's determination to implement a Vesting-Date Payout and, in fact, would normally prefer to take a permissible closing-date payment rather than continue to be subject to a Vesting Condition (particularly in light of the change in ownership of their employer). In addition, these payments are rarely if ever secured.

Accordingly, Vesting-Date Payouts do not offend any of the policy concerns that IRC Section 409A is intended to address with respect to stock options and SARs, and the IRS should clarify in official guidance that Vesting-Date Payouts do not constitute impermissible "extensions" of stock options or SARs. This clarification will validate historically permissible, non-abusive stock option and SAR practices[83] and greatly reduce unwarranted restrictions on legitimate business practices and uncertainty for taxpayers, improvements that are desperately needed in the area of IRC Section 409A.

¶ 603 LIQUIDITY EVENT PAYMENT TRIGGERS

IRC Section 409A provides that (i) a change in control event meeting specified

---

[82] By contrast, the Enron stock deferral program permitted participants to affirmatively elect to defer option shares into phantom shares (and thus defer tax) for a period of 1–15 years or until death or disability, retirement or termination, and to be credited with dividends over this deferral period. *See* JCT Enron Report, *supra* note 6, at 631–32. These true option gain deferral programs are the intended target of the "extension" rules described above, by contrast to Vesting-Date Payouts which permit no deferral beyond the original vesting date of the stock option or SAR.

[83] Congress did not intend to classify ordinary course stock options and SARs as Deferred Compensation. *See, e.g.*, HR REP NO 108-755, at 735 (2004) (Conf Rep) ("For purposes of [IRC Section 409A], it is not intended that the term 'nonqualified deferred compensation plan' include an arrangement taxable under section 83 providing for the grant of an option on employer stock with an exercise price that is not less than the fair market value of the underlying stock on the date of grant if such arrangement does not include a deferral feature other than the feature that the option holder has the right to exercise the option in the future.").

criteria set forth in IRC Section 409A (a "***CIC***") will constitute a permissible payment event for Deferred Compensation,[84] and that (ii) an initial public offering of a company's securities (an "***IPO***") may constitute a Vesting Condition for purposes of applying the STDE to Exempt Payments.[85] However, IRC Section 409A does not necessarily treat an IPO as a permissible payment event for amounts that constitute Deferred Compensation, nor does it identify a CIC as a potential Vesting Condition.[86] As a result of this disparate treatment of conceptually similar corporate events, substantial challenges (and resulting uncertainty) arise when structuring transaction-based payment events linked to liquidity.[87]

¶ 603.1 Overview of Applicable Regulatory Provisions

IRC Section 409A provides in relevant part that Transaction-based payments can avoid IRC Section 409A Penalties through proper structuring as either IPO payments that qualify for the STDE or Deferred Compensation that is payable upon a CIC.[88] The following regulatory provisions provide the framework for these liquidity event payment triggers:

A. IPO as STDE Exempt Payment Event

As discussed in ¶ 601.1 above, the STDE treats as a permissible Exempt Payment an amount that the Employee actually or constructively receives within the "applicable 2 ½ month period" following the vesting of such payment (if such payment is not otherwise a deferred payment).[89] For purposes of IRC Section 409A, a Vesting Condition exists with respect to a payment if the payment "is conditioned on . . . the occurrence of a condition related to a purpose of the compensation, and the possibility

---

[84] IRC § 409A(a)(2)(A)(v) (2006); Treas Reg § 1.409A-3(a)(5) (2007).

[85] Treas Reg § 1.409A-1(d)(1).

[86] IRS representatives have acknowledged that a CIC could theoretically constitute a Vesting Condition, but have declined to specifically identify it as such, *see, e.g.*, JCEB May 2009 Meeting, *supra* note 36, Q&A 31, or to offer any guidance on the circumstances under which a CIC would constitute a Vesting Condition (by contrast to an IPO, which the IRC Section 409A regulations specifically enumerate as a potential Vesting Condition in Treas Reg § 1.409A-1(d)(1)).

[87] For example, if a start-up company wants to grant equity awards or cash bonus rights that pay out if and when the company achieves liquidity, a legitimate non-tax business objective, the company must choose between paying out on an IPO or a CIC in order to avoid the substantial uncertainty that would arise if the company structured the awards in a manner that paid on either such outcome.

[88] There are a number of additional payment timing mechanisms available for structuring payments that are not subject to IRC Section 409A Penalties (*e.g.*, specified time or fixed schedule, separation from service, unforeseeable emergency, disability, separation pay exceptions, etc.); however, these alternative payment structures generally do not prove useful in structuring liquidity-based payments.

[89] Treas Reg § 1.409A-1(b)(4)(i).

of forfeiture is substantial."[90] IRC Section 409A further requires that "a condition related to a 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."[91] Based on these parameters, IRC Section 409A identifies IPOs as an example of a potential Vesting Condition[92] and thus a potential permissible STDE Exempt Payment trigger.

B. CIC as Permissible Deferred Compensation Payment Event

IRC Section 409A designates CICs as a permissible payment event for Deferred Compensation as follows: "[a] plan may permit a payment upon the occurrence of a change in the ownership of the corporation . . . , a change in effective control of the corporation . . . , or a change in the ownership of a substantial portion of the assets of the corporation . . . . To qualify as a change in control event, the occurrence of the event must be objectively determinable . . . ."[93]

¶ 603.2 Discussion and Analysis

As discussed in ¶ 601 above, (i) STDE payments generally must be payable by their terms no later than the expiration of the applicable 2 ½ month period following vesting, and (ii) under current guidance, a determination of whether payments are payable by their terms within the applicable 2 ½ month period would, most prudently, be made at the time the legally binding right arises (*i.e.*, the grant or contract date), meaning that a payment often cannot qualify as both an Exempt Payment under the STDE and a compliant CIC payment because the period between vesting and the occurrence of the CIC may be too long.[94]

---

[90] *Id.* § 1.409A-1(d)(1). Note that the definition of Vesting Condition for IRC Section 409A purposes (i.e., the definition of "substantial risk of forfeiture") is somewhat narrower than the definition used for Internal Revenue Code Section 83 purposes (relating to compensatory transfers of property). *Compare id., with* Treas Reg § 1.83-3(c) (as amended in 2005). The IRS declined to harmonize these definitions, citing different policy concerns and practical differences between restricted property transfers and deferred compensation. TD 9321, 2007-1 CB 1123, 1141. However, even using IRC Section 409A's narrower definition, it seems that a CIC should qualify as a Vesting Condition to the same extent as an IPO so qualifies, as discussed herein.

[91] Treas Reg § 1.409A-1(d)(1).

[92] *Id.*

[93] *Id.* § 1.409A-3(i)(5)(i). *See also* IRC § 409A(a)(2)(A)(v) (2006) (granting the Treasury authority to prescribe the circumstances under which a CIC is a permissible distribution event).

[94] This conclusion assumes that the CIC in question is not a valid Vesting Condition in and of itself (and that the performance of "substantial services" is not required through the consummation of the CIC)—as discussed below, a CIC may in fact constitute a valid Vesting Condition, but there is no clear guidance on this point. Accordingly, relying on a CIC as a Vesting Condition creates uncertainty and risk in and of itself.

In addition, permissible CIC payments may be made on an objective schedule following the CIC over a period that is, by its terms, too long to qualify for the STDE. As a result, it is often difficult or impossible to structure transaction payments and awards to be payable in connection with the first to occur of an IPO or CIC. As discussed below, IRC Section 409A contains provisions that can be read to permit IPO as a viable permissible payment event for Deferred Compensation, and these provisions should be interpreted in this manner. In addition, CICs should generally qualify as valid Vesting Conditions which would permit structuring Exempt Payments that occur on the first to occur of a qualifying IPO or a CIC under the STDE.

¶ 603.3 IPO Should Qualify as a Permissible Deferred Compensation Payment Event

A. Legitimate, Objective Event

An IPO is a legitimate, objective, private-company business strategy, the manipulation of which is generally beyond the control of Employees and thus not readily subject to abuse. In addition, the costs, risks and organizational efforts associated with an IPO, coupled with the consequences of becoming a publicly traded company, render potential use of an IPO as an abusive compensation deferral vehicle virtually nil.[95] An IPO generally represents a key organizational objective for a private company and, like a CIC, is often the most logical payment event for certain types of incentive compensation. Consequently, its absence from the list of permissible payment events disrupts legitimate compensation planning while serving no identifiable policy goal.

B. IPO Payments May Already Be Permissible

As discussed above, IRC Section 409A explicitly provides that an IPO may constitute a Vesting Condition. By extension, some practitioners take the position that IRC Section 409A therefore already permits Deferred Compensation payments that are paid on an objective schedule determined by reference to an IPO (*i.e.*, because an IPO can constitute a Vesting Condition),[96] subject to certain limitations (discussed below).

---

[95] Similar points were raised in an ABA letter responding to the proposed IRC Section 409A regulations in 2006. *See* Letter from ABA Section of Taxation to Mark W. Everson, Comm'r, Internal Revenue Serv. 11–12 (June 15, 2006) [hereinafter "***ABA Comment Letter***"], *available at* http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2006/061506section409aproposedregs_distribution.authcheckdam.pdf. These points remain unaddressed and equally relevant today.

[96] IRC Section 409A provides explicitly that compliant Deferred Compensation payments may be made "upon the lapse of a substantial risk of forfeiture . . . in accordance with a fixed schedule that is objectively determinable based on the date the substantial risk of forfeiture lapses." Treas Reg § 1.409A-3(i)(1)(i). This position is distinguishable from the alternate treatment of IPO-based payments as Exempt Payments payable under the STDE upon the lapsing of a Vesting Condition, in that the post-IPO payment window for a Deferred Compensation payment may extend beyond the applicable 2 ½ month period, while STDE payments made upon a lapsing Vesting Condition may not. Reliance on the

From there, we can readily extend this logic to further conclude that payment *upon* an IPO constitutes an objective schedule determined by reference to the IPO, and that IPOs are thus permissible Deferred Compensation payment events. However, due to the notable omission of IPOs from IRC Section 409A's enumerated permissible payment events for Deferred Compensation, practitioners more commonly take the position that payments upon or in connection with IPOs are not permissible with respect to Deferred Compensation (by contrast to IPO payments that constitute Exempt Payments under the STDE).

C. Room Exists Within Statutory Limitations to Specifically Permit IPO Payments by Regulation

1. Statutory Payment Events

The statutory language of IRC Section 409A permits distributions of Deferred Compensation only upon six specified events: separation from service, disability, death, specified time or fixed schedule ("***Specified-Time Payments***"), change in ownership or effective control and unforeseeable emergency.[97] By hard-wiring these payment events into the statute, Congress limited regulatory flexibility to identify and implement additional appropriate payment events for Deferred Compensation, such as IPOs. However, though IPOs are notably absent from this list of permissible Deferred Compensation payment events, there appears to be no discussion of IPOs in the legislative history at all,[98] which suggests that Congress at least had no specific intent to generally prohibit IPO payment events for Deferred Compensation.

2. IPO as Specified-Time Payment

Notwithstanding the statutory limitations imposed on permissible payment events under IRC Section 409A, the regulations do in fact read a degree of flexibility into the statute as it applies to Specified-Time Payments. Specifically, the regulations provide that a payment will qualify as a Specified-Time Payment if the payment is made on a fixed schedule that is objectively determinable based on the date that a Vesting Condition lapses, so long as (i) the schedule is fixed on the date the time and form of

---

STDE with respect to IPO payments further creates uncertainty for "liquidity" payments that are also linked to CICs, because it is not clear whether or under what circumstances a CIC (or, for that matter, an IPO) will constitute a Vesting Condition.

[97] IRC § 409A(a)(2)(A).

[98] *See, e.g.*, STAFF OF THE JOINT COMM. ON TAXATION, JCX-85-08, TECHNICAL EXPLANATION OF HR 7327, THE "WORKER, RETIREE, AND EMPLOYER RECOVERY ACT OF 2008," AS PASSED BY THE HOUSE ON DECEMBER 10, 2008 (2008); JCT 2006 Report, *supra* note 15; STAFF OF THE JOINT COMM. ON TAXATION, JCX-38-06, TECHNICAL EXPLANATION OF HR 4, THE "PENSION PROTECTION ACT OF 2006," AS PASSED BY THE HOUSE ON JULY 28, 2006, AND AS CONSIDERED BY THE SENATE ON AUGUST 3, 2006 (2006); HR REP NO 108-755 (2004) (Conf Rep); HR REP NO 108-548, pt. 1 (2004); JCT Enron Report, *supra* note 6.

payment are designated, and (ii) any discretionary acceleration of the lapse of the Vesting Condition is disregarded.[99] Significantly, this component of Specified-Time Payments demonstrates that events which are not statutorily enumerated can form the basis for compliant IRC Section 409A Deferred Compensation payment arrangements.[100]

Accordingly, the IRS could specifically provide that an objective, fixed payment schedule determined by reference to the occurrence of an IPO that otherwise meets the conditions described above (rather than by reference to the lapsing of a Vesting Condition, which may or may not include an IPO), constitutes a permissible payment event for deferred compensation under IRC Section 409A. Moreover, regulators would not need to broaden the scope of their existing regulatory framework to do so (nor would they offend identifiable policy considerations concerning permissible payment events), since the regulations already permit payments by reference to lapsing Vesting Conditions, which are not statutorily enumerated Deferred Compensation payment events.

3. IPO as a CIC

Additionally, an IPO could arguably constitute a CIC in certain circumstances and thus serve as a permissible Deferred Compensation payment event under the CIC prong. However, by contrast to Congress's lack of specific intent with regard to IPOs as Specified-Time Payments, Congress apparently did intend some additional rigidity with regard to the scope of CICs as permissible payment events—specifically, IRC Section 409A's legislative history notes in multiple places that the applicable definition of CIC under IRC Section 409A should be narrower than the corresponding definition under Internal Revenue Code Section 280G (which governs "golden parachute" payments).[101]

Congress did provide some flexibility under IRC Section 409A(a)(3) with regard to statutory payment events (including CICs) by reserving regulatory authority to the IRS to identify "permissible payment accelerations" with respect to these permissible payment events. Accordingly, the IRS could seemingly validate IPOs as permissible Deferred Compensation payment events (at least partially) through regulations classifying IPOs as permissible "acceleration events" with respect to a CIC (*i.e.*, an

[99] Treas Reg § 1.409A-3(i)(1)(i).

[100] Note that there is some indication in the legislative history that event-based payments should not be eligible to qualify as Specified-Time Payments, *see* HR Rep No 108-755, at 730; however, this limitation does not appear in the statute and the IRS apparently declined to follow this approach in its regulations as well.

[101] *See, e.g.*, HR Rep No 108-755, at 730; HR Rep No 108-548, pt. 1, at 344; TD 9321, 2007-1 CB 1123, 1156-57.

IPO could arguably constitute a permissible payment if payment were formulated as "the earlier of a CIC or an IPO").[102]

Of course, this solution would address only part of the issue, as IPOs would still be unavailable as permissible payment events for Deferred Compensation in the absence of a corresponding CIC payment trigger. In addition, in light of the legislative history around the CIC definition contained in IRC Section 409A, the argument for IRC Section 409A IPO payment events is stronger under the Specified-Time Payment provisions discussed above than it is here under the CIC payment provisions.

¶ 603.4 CIC Should Qualify as a Vesting Condition

As discussed above, in order to constitute a Vesting Condition, a condition must require either (i) the performance of substantial services[103] or (ii) the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture must be substantial.[104] A condition related to a purpose of the compensation must relate to the service provider's performance for the service recipient (or its business activities or organizational goals). The regulations already identify IPOs as potential Vesting Conditions,[105] and there is no conceptual basis for any different result with respect to CICs.

Presumably, the regulations permit certain IPOs to qualify as valid Vesting Conditions because (i) private companies commonly target an IPO as a goal for the organization to attain growth and for founders and other equity holders (often including Employee equity holders) to attain liquidity with respect to the asset they have helped to build, and (ii) tremendous commitment and effort are required across a broad array of officers and other Employees to attain this goal. There is no conceptual distinction between IPOs and CICs in this regard—CICs are just as likely as IPOs to constitute organizational goals targeting liquidity and/or growth and requiring similar performance levels from officers and employees.[106] In fact, in practice, CICs are

---

[102] This possibility was previously proposed in comments to the Proposed Regulations, but was not adopted by the Secretary. *See* ABA Comment Letter, *supra* note 95, at 11–12. Another commentator proposed direct inclusion of IPOs in the CIC permissible payment event. *See* Letter from the Emp. Benefits Comm., Chi. Bar Ass'n, to Eric Solomon, Acting Assistant Sec'y (Tax Policy), Deputy Assistant Sec'y for Regulatory Affairs, Dep't of the Treasury, and Nancy J. Marks, Associate Chief Counsel (TEGE), Internal Revenue Serv. 1–2 (Aug 4, 2005), *available at* TNT Doc 2005-18952.

[103] This discussion assumes that the "substantial services" prong of the test is not separately satisfied and instead analyzes the application of the second prong of the test.

[104] *See supra* ¶ 603.1.A.

[105] *See generally* Treas Reg § 1.409A-1(d)(1) (2007).

[106] Of course, there are other attributes of an IPO that are not necessarily common to a CIC transaction, including access to capital markets and marketplace prominence, but these distinctions in no way diminish the stature of a CIC transaction as business activity or organizational goal that may serve

regularly identified with IPOs as alternative (but equally desirable) goals for private companies.

The regulations do not offer relevant guidance as to when a risk of forfeiture is substantial.[107] Instead, taxpayers must apply a subjective, facts and circumstances test in making this determination. In the abstract (*i.e.*, when IPOs and CICs are organizational ambitions existing prior to the commencement of either such process), the potential nonoccurrence of either an IPO or a CIC would seem to easily satisfy this test (at least in the context of a new start-up company), as there are a multitude of factors that can and often do foreclose the possibility of either such event.[108] These factors include, but are not limited to, company performance, applicable market conditions, the broader economy and/or the absence of necessary leadership or personnel. Even for companies that commence and progress far into an IPO or sale process, in many cases, the potential non-occurrence of the event often remains significant until the transaction is affirmatively closed or launched, as applicable, for the same reasons that the potential non-occurrence of the event was significant at the outset. In fact, it is not at all uncommon for contemplated IPOs or CICs to fail just prior to launch or closing.

This point is commonly acknowledged by the ancillary agreements that often accompany IPO and CIC transactions (*e.g.*, employment agreements, equity awards, etc.), which typically contain express limitations conditioning the effectiveness of these agreements upon the closing or launch of the IPO or CIC, due to the ever-present possibility that the transaction will fail for one reason or another. In any event, the assessment of whether the potential non-occurrence of an IPO or CIC is "substantial" may require a facts and circumstances analysis, but there is no conceptual distinction between an IPO and a CIC for purposes of applying this analysis. Accordingly, CICs, like IPOs, should be recognized by IRC Section 409A as potential Vesting Conditions.

¶ 603.5 Limited Official Interpretations

Though strong support exists under IRC Section 409A for the treatment of IPOs as valid payment events for Deferred Compensation and the treatment of CICs as valid Vesting Conditions for Exempt Payments, there is very little interpretive guidance on these topics (and no published materials upon which reliance would be permitted). Following are the key examples of available guidance:

---

as a condition related to a purpose of the compensation paid to an Employee.

[107] The regulations do discuss whether the possibility of forfeiture is substantial in the context of rights granted to an Employee who may effectively control the service recipient, *see* Treas Reg § 1.409A-1(d)(3)), but those provisions are not relevant to this IPO/CIC discussion.

[108] Note that the non-occurrence of an IPO or CIC is arguably less certain following a buy-out of the company in which the acquirer's primary acquisition goal is the ultimate disposition of the company for a profit (*e.g.*, in the private equity context).

A. CIC as Vesting Condition

IRS representatives have on occasion indicated in phone conversations a willingness to consider circumstances in which a CIC could constitute a Vesting Condition.[109] The IRS has also acknowledged in at least one instance (again, unofficially) that a CIC may constitute a Vesting Condition where the consummation of the CIC must occur within six months after a qualifying termination of employment pursuant to the applicable employment agreement.[110]

B. IPO as Permissible Payment Event

There does not appear to be any published guidance from the IRS on this point.

¶ 603.6 Key Policy Considerations Around Payment Events

The Key Policy Goals to consider in connection with IPO and CIC payment events include: (i) the disallowance of illusory Vesting Conditions; (i) the limitation of abusive re-deferrals of compensation; (iii) the regulation of common deferral techniques and (iv) the limitation of participant control over payment timing. One commentator has also interpreted the IRC Section 409A policy goals in the context of permissible payment events to include concerns around access to deferred amounts prior to permissible distribution events.[111]

IRC Section 409A identifies IPOs as an example of a valid Vesting Condition and, as discussed above, the rationale for this determination applies equally to CICs, meaning that concern over illusory Vesting Conditions is no more justified in the proposed CIC context than it is in the accepted IPO context. In addition, there is no potential for abusive practices inherent in CIC or IPO payment events with respect to Deferred Compensation, as both events are easily defined in objective terms, the modification of which is typically outside of an Employee's control. Finally, due to the objectively identifiable nature of these events, there is generally little or no Employee control over payment timing once that timing is initially established. Accordingly, neither treating IPOs as permissible Deferred Compensation payment events nor treating CICs as valid Vesting Conditions should offend any applicable IRC Section 409A policy goal.

---

[109] These phone conversations involved the author, certain of the author's colleagues and various IRS representatives, but no published guidance is available on this point.

[110] *See* JCEB May 2010 Meeting, *supra* note 32, Q&A 24. IRS representatives have also acknowledged this possibility in various discussions, but there is currently no published guidance acknowledging a CIC as a potential Vesting Condition or providing any parameters around when a CIC would or would not qualify as a Vesting Condition.

[111] *See* Polsky, *supra* note 2, at 643 ("The purpose of the permissible distribution rules was to ensure that, once compensation is deferred, it may not be easily accessed by the service provider earlier than the normal distribution date or deferred beyond that date.").

¶ 603.7 Best Practices Under Current Guidance

While there are reasonable bases for positions that would permit rights that are payable on both CIC and IPO events, the risk associated with these positions may outweigh the potential benefit of the more flexible structures they permit. Following are suggestions for best practices, listed in order from least to most aggressive:

A. Choose Either IPO or CIC Payout

In the absence of clarity around whether an IPO can be a permissible Deferred Compensation payment event or a CIC can constitute a Vesting Condition, it is safest to structure liquidity event payments that constitute either permissible payments upon a valid CIC or Exempt Payments payable upon the satisfaction of a valid IPO Vesting Condition, but not to provide for payout on both events.

B. Use Outside Payment-Date to Combine IPO and CIC as Permissible Deferred Compensation Payments

A company may elect to make liquidity event payments on the first to occur of a CIC or a Specified-Time Payment date that is expected to occur after any IPO, such as an anniversary of the grant/contract date (*e.g.*, payment upon the earlier of a CIC or the seventh anniversary of the grant/contract date). This approach may not be commercially desirable though, both because of the potential for significant payment delay between an IPO and the designated Specified-Time Payment and because the Specified-Time Payment could ultimately precede any liquidity event.

C. Add Conditions to Create Exempt Payments

If both CIC and IPO payouts will be included in an Exempt Payment arrangement, consider limiting the CIC with a deadline and/or a price or other performance threshold to increase the likelihood of its non-occurrence (and thus the validity of the asserted Vesting Condition). Note that this approach applies equally to IPOs, though there may be less concern around the validity of the IPO as a Vesting Condition due to the fact that IRC Section 409A identifies IPOs as such (by contrast to CICs).

D. Include Objective Timing to Create a Permissible Payment Event

If transaction payments will be structured as Deferred Compensation rights payable on both CIC and IPO, make sure that the IPO payment timing includes a schedule that is linked to the IPO and which is objectively determinable from the outset (and which disregards discretionary acceleration of the lapse of the Vesting Condition).

¶ 603.8 Proposed Relief

Payments upon IPOs and CICs incentivize legitimate organizational goals which create little or no opportunity for abusive compensation practices and do not otherwise offend any policy considerations targeted by IRC Section 409A. The absence of IPOs from the list of permissible Deferred Compensation payment events under IRC Section

409A creates substantial uncertainty and risk around this transaction/liquidity-based compensation planning. The further lack of clarity as to whether and when CICs will constitute Vesting Conditions exacerbates this uncertainty and the corresponding risk.

The IRS should first and foremost clarify in official guidance that objectively determinable payment schedules linked to IPOs (including payment upon IPOs) constitute valid Specified-Time Payments. In addition, the IRS should clarify in official guidance that CICs may constitute Vesting Conditions to the same extent as IPOs. Finally, the IRS should identify a safe harbor, or at least specific factors, which indicate under what circumstances an IPO or CIC constitutes a valid Vesting Condition.