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Internal Revenue Service  
**Memorandum**

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subject: Application of Section 409A to the Exercise of Certain Backdated Stock Options in 2006

This replies to your request for assistance on the application of §409A to certain exercises of backdated stock options in 2006. Application of the guidance under §409A depends largely on the particular facts and circumstances of the compensation arrangement and the particular actions taken under the compensation arrangement. Accordingly, the advice provided in this memorandum should not be applied beyond the facts discussed.

**FACTS:**

Employee A and Employee B are employees of a corporation, Employer Z. On July 1, 2003, Employer Z, which has only one class of common stock outstanding, granted Employee A and Employee B compensatory nonstatutory stock options to purchase common stock of Employer Z. Under the terms of the stock options, the options were not exercisable until July 1, 2005 and would be forfeited if the employee did not continue in employment through July 1, 2005. On July 1, 2003, the fair market value of the underlying stock was \$2 per share. The exercise price of the stock options was \$1 per share. Under the terms of the stock options, the options would terminate on the

earlier of July 1, 2013 or the 90<sup>th</sup> day following the employee's termination of employment. Employee A terminated employment on February 1, 2006. Employee B has not terminated employment. On February 15, 2006, Employee A and Employee B each exercised his or her stock option. Neither Employee A nor Employee B was a key employee of Employer Z (as defined in §416) at any time. The stock options have never been modified or extended.

**ISSUE:**

Were the stock options subject to §409A, and did the stock option exercises result in a violation of section §409A?

**RESPONSE:**

The stock options were nonqualified deferred compensation plans subject to §409A. Employee A's stock option exercise in 2006 did not violate the requirements of §409A. Employee B's stock option exercise in 2006 violated the requirements of §409A. For a discussion of the amount required to be included in income in 2006, see Notice 2006-100, 2006-51 IRB 1109.

**DISCUSSION:**

**1. Applicable Guidance**

Section 409A applies to amounts deferred under a nonqualified deferred compensation plan. The final regulations under §409A are applicable for taxable years beginning after December 31, 2007. For taxable years beginning before January 1, 2008, the applicable guidance under §409A (including transition guidance) is Notice 2005-1, 2005-1 CB 274, the preamble to the Proposed Regulations under §409A, 2005-2 CB 786 (70 FR 57930), and Notice 2006-79, 2006-43 IRB 763. For taxable years beginning before January 1, 2007, the guidance provides that the taxpayer must comply with the requirements of Notice 2005-1, as well as any other applicable guidance as of its effective date. With respect to issues not addressed by Notice 2005-1, taxpayers may rely upon a reasonable, good faith interpretation of the statute. For this purpose, compliance with the proposed regulations or final regulations constitutes compliance with a reasonable, good faith interpretation of the statute. Where a provision of the regulations is inconsistent with Notice 2005-1, the taxpayer may comply with the provisions of the regulations or Notice 2005-1. See Notice 2005-1, Q&A-19; Preamble to the Proposed Regulations under §409A, § XI.B; Notice 2006-79, §3.01, and Preamble to the final Regulations under §409A, Applicability Date.

**2. Coverage under § 409A**

A stock option is subject to §409A if the option constitutes a nonqualified deferred compensation plan for purposes of §409A. Whether a stock option is a deferred

compensation plan requires analysis of whether the option provides for the deferral of compensation, including whether the option provides for only a short-term deferral of compensation, and whether the option is excluded from coverage under §409A under the effective date provisions.

#### **A. Definition of Nonqualified Deferred Compensation Plan – In general**

Notice 2005-1, Q&A-4(a) states that a plan provides for the deferral of compensation only if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year. The proposed regulations adopt a substantially similar standard. See Prop. Treas. Reg. §1.409A-1(b)(1). The final regulations exclude the condition that the amount not be actually or constructively received to avoid confusion with respect to the rules on deferral elections and accelerations of payments. See Preamble to the Final Regulations under §409A, §III.A; Treas. Reg. §1.409A-1(b)(1). Because the stock options granted by Employer Z provide a legally binding right to a payment in a future year, the arrangement provides for the deferral of compensation, absent an applicable exclusion.

Notice 2005-1, Q&A-4(d)(ii) provides that an option to purchase stock of the service recipient, other than an incentive stock option described in §422 or an option granted under an employee stock purchase plan described in §423, does not provide for a deferral of compensation if: (1) the amount required to purchase stock under the option (the exercise price) may never be less than the fair market value of the underlying stock on the date the option is granted, (2) the receipt, transfer or exercise of the option is subject to taxation under §83, and (3) the option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of exercise or disposition of the option under §1.83-7. The regulations adopt a substantially similar standard. See Prop. Treas. Reg. §1.409A-1(b)(5)(i)(A); Treas. Reg. §1.409A-1(b)(5)(i)(A). Because the exercise prices of the stock options were less than the fair market value of the underlying stock on the date the options were granted, this exception is not available.

#### **B. Definition of Nonqualified Deferred Compensation Plan – Short-Term Deferrals**

Notice 2005-1, Q&A-4(c) provides that until additional guidance is issued, 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 received by the service provider by, the later of (i) the date that is 2½ months from the end of the service provider's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture or (ii) the date that is 2½ months from the end of the service recipient's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture. Because the stock options otherwise

defer the payments to a later period, and do not require that the payment be made by the end of the applicable period, the options do not qualify for this exclusion.

Taxpayers may also rely upon the proposed or final regulations. The proposed regulations altered this exclusion from coverage under §409A, generally eliminating the requirement that a plan require that the payment be made by the end of the applicable period. Specifically, proposed §1.409A-1(b)(4)(i) provides that a deferral of compensation does not occur if, absent an election by the service provider (including an election under proposed §1.409A-2(a)(4)) to otherwise defer the payment of the compensation to a later period, an amount is actually or constructively received by the service provider by the later of the 15<sup>th</sup> day of the third month following the service provider's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture or the 15<sup>th</sup> day of the third month following the end of the service recipient's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture. Proposed §1.409A-2(a)(4) also requires that the arrangement not otherwise defer the payment to a later period. The preamble to the proposed regulations explained that "where an arrangement does not otherwise defer compensation, an amount will qualify as a short-term deferral ... if the amount is paid out by the appropriate deadline." Preamble to the Proposed Regulations under §409A, §II.B. For example, an arrangement that defers a payment until 5 years after the lapsing of a condition that constituted a substantial risk of forfeiture constitutes a deferral of compensation even if the amount is actually paid on the date the substantial risk of forfeiture lapses.

Under this standard, a stock option with a term permitting exercise beyond the applicable short-term deferral period would not constitute a short-term deferral, regardless of whether the option was actually exercised during such period, because the arrangement would otherwise defer the payment to a later period. Once an arrangement provides for deferred compensation, the arrangement cannot be treated as a short-term deferral. See also Preamble to the Proposed Regulations under §409A, §II.B (the short-term deferral rules does not provide a method to avoid application of §409A if the legally binding right creates a right to deferred compensation from the outset). For rules applicable in taxable years beginning after December 31, 2007, see Treas. Reg. §1.409A-1(b)(4)(i)(E) and §1.409A-1(b)(4)(iii), Example 8.

### **C. Application of Transition Guidance**

The preamble to the proposed regulations provides that to comply with the requirements of §409A, a plan must be amended on or before December 31, 2006 either to conform to the provisions of §409A with respect to amounts subject to §409A, or to provide a compensation arrangement that does not provide for a deferral of compensation for purposes of §409A. Preamble to the Proposed Regulations under §409A, §XI.B. Some taxpayers have argued that the exercise of a stock option should be treated as a de facto amendment of the option to no longer provide for a deferral of compensation, if such exercise occurs during the period ending 2 ½ months after the end of the taxable

year in which the option became vested. If this argument were accepted, a payment under a nonqualified deferred compensation plan under a payment provision that did not meet the requirements of §409A would also be treated as amending the plan to pay under a different, permissible provision. For example, a payment under a plan term permitting a payment at the participant's election subject to a penalty (a haircut provision) that happened to coincide with the participant's separation from service arguably could be a payment upon a separation from service, even if the plan did not otherwise provide for a payment upon a separation from service.

The transitional guidance does not permit these types of de facto amendments for payments that occurred during 2006, because the purported de facto amendment would be a change in a payment election. The taxpayers could have amended the stock options in 2005 to be compliant with §409A by requiring that the option be exercised in 2006. See Notice 2005-1, Q&A-19(c). However, the transition rules do not allow a taxpayer to amend a plan during 2006 to provide for a payment in 2006. In this regard, the preamble to the proposed regulations provides that with respect to amounts subject to §409A and amounts that would be treated as a short-term deferral, such an amendment and election will not be treated as a change in the form and timing of a payment under §409A(a)(4) or an acceleration of a payment under §409A(a)(3), provided that the amendment and election applies only to amounts that would not otherwise be payable in 2006 and does not cause an amount to be paid in 2006 that would not otherwise be payable in such year. See Preamble to the Proposed Regulations under §409A, §XI.C. Because the amount payable under the stock option was not otherwise payable in 2006, the option could not be amended in 2006 to require that the payment be made in 2006. See Notice 2006-79, §3.02 (for this purpose, a stock right will not be treated as payable in a year solely because the stock right is exercisable during that year, if the stock right is also reasonably expected to be exercisable in a subsequent year). Accordingly, the transition rules did not permit the taxpayers to amend the stock options at issue here in 2006 to qualify such options as arrangements providing only short-term deferrals, so as to exclude the options from the definition of a nonqualified deferred compensation plan.

The preamble to the final regulations provides that with respect to payments before January 1, 2008, a taxpayer is not required to amend the plan retroactively to reflect the changes and elections made during the transition period. However, the taxpayer must be able to demonstrate that any such changes and elections were made in compliance with the applicable transition guidance. Because the election to exercise the stock option in 2006 was made in 2006, and not in 2005, the taxpayer would not be able to demonstrate that the changes and elections were made in compliance with the applicable transition guidance.

#### **D. Application of §409A - Effective Date**

Notice 2005-1, Q&A-16(a) provides generally that §409A is effective with respect to (i) amounts deferred in taxable years beginning after December 31, 2004; and (ii) amounts

deferred in taxable years beginning before January 1, 2005 if the plan under which the deferral is made is materially modified after October 3, 2004. Section 409A is effective with respect to earnings on amounts deferred only to the extent that §409A is effective with respect to the amounts deferred.

Notice 2005-1, Q&A-16(b) provides that for purposes of determining whether §409A is effective with respect to an amount, the amount is considered deferred before January 1, 2005 if (i) the service provider has a legally binding right to be paid the amount and (ii) the right to the amount is earned and vested. For this purpose, a right to an amount is earned and vested only if the amount is not subject to either a substantial risk of forfeiture (as defined in §1.83-3(c)) or a requirement to perform further services.

The proposed and final regulations incorporate substantially the same standards. See Prop. Treas. Reg. §1.409A-6(a), Treas. Reg. §1.409A-6(a)(2). Because the employees' rights under the stock options were not earned and vested before January 1, 2005, the stock options are not excluded from coverage under §409A due to application of the effective date provisions.

### **3. Compliance with the Requirements of §409A**

Notice 2005-1 generally did not address the application of the requirements under §409A. Accordingly, for periods on or before December 31, 2007, the nonqualified deferred compensation plan comprised of the stock option generally will not be treated as violating §409A if the plan is operated through December 31, 2007 in reasonable, good faith compliance with the provisions of §409A and any other generally applicable guidance published with an effective date before January 1, 2008 and, to the extent not inconsistent therewith, the plan's terms. In the case of a stock option, this means that the option generally must be operated in reasonable, good faith compliance with §409A(a)(2)(A), which requires that compensation deferred under a nonqualified deferred compensation plan may only be payable upon certain events, including (i) a separation from service; (ii) disability; (iii) death; (iv) a specified time or fixed schedule; (v) a change in control event; or (vi) an unforeseeable emergency.

The ability to exercise a stock option at any time during the option term, where the term extends over multiple years, does not meet the requirements of §409A(a)(2)(A). During the taxable year 2005, neither Employee A nor Employee B exercised his or her respective stock option. Thus during 2005, the plan was operated in reasonable, good faith, compliance with §409A(a)(2)(A), because neither employee made use in operation of the noncompliant provision of the plan (that is, the right to exercise the option at any time). In 2006, both Employee A and Employee B exercised their option. When Employee A terminated employment in 2006, the term of Employee A's stock option became limited and would expire 90 days later. Employee A exercised the stock option within those 90 days. Under a reasonable, good faith, interpretation of §409A, Employee A exercised the stock option under the option terms permitting exercise upon a separation from service, which complies with the requirements of §409A(a)(2)(A).

Accordingly, Employee A's stock option exercise did not violate the requirements of §409A. Employee B did not terminate employment in 2006, so the term of Employee B's stock option was not so limited. Employee B exercised Employee B's stock option under the option terms permitting exercise at any time after vesting and during the 10-year term of the option. This constitutes the use in operation of a plan term that is not consistent with a reasonable, good faith interpretation of the statute, or with the transition guidance, and accordingly violates the requirements of §409A.