

**Office of Chief Counsel  
Internal Revenue Service  
memorandum**

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to: Associate Area Counsel

from: Executive Compensation Branch, Tax Exempt & Government Entities

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subject: Tax Matter

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Parent =

Plan =

Option Shares =

Exercise Price =

Dividend =

Adjusted Exercise Price =

Day 1 =

Day 2 =

Day 3 (                      Date) =

Day 1 Lowest Price =

Day 2 Lowest Price =

Day 3 Lowest Price =

Year 1 =

Year 2 =

Year 3 =

Year 1 Closing Price =

Year 2 Closing Price =

Year 3 Closing Price =

Year 2 Exercised Shares =

Year 3 Exercised Shares =

Unadjusted Shares =

Adjusted Shares =

Unexercised Unadjusted Shares =

Unexercised Unadjusted Spread =

Unexercised Unadjusted Amount =

Unexercised Adjusted Shares =

Unexercised Adjusted Spread =

Unexercised Adjusted Amount =

Exercised Unadjusted Amount =

Total Deferred Amount =

20% Tax Amount =

## ISSUES

1. What is the grant date of the taxpayer's nonstatutory stock option for purposes of section 409A of the Internal Revenue Code (Code) if, under the circumstances described below, the option agreement was entered into prior to \_\_\_\_\_, subject to additional corporate action, and effective \_\_\_\_\_ ?
2. Is stock traded on a when-issued, over-the-counter market readily tradable on an established securities market for purposes of determining the fair market value of service recipient stock underlying a nonstatutory stock option that is intended to be exempt from section 409A?
3. How is the amount of the income inclusion, additional 20% income tax, and additional interest income tax under section 409A(a)(1) calculated due to the failure of the taxpayer's nonstatutory stock option to meet the requirements of section 409A(a) under the circumstances described below?

## CONCLUSIONS

1. The grant date of the taxpayer's nonstatutory stock option for purposes of section 409A is the date on which the conditions for grant of the option were completed, which was \_\_\_\_\_.
2. Stock traded on a when-issued, over-the-counter market is readily tradable on an established securities market for purposes of determining the fair market value of service recipient stock underlying a nonstatutory stock option. For the option to be exempt from section 409A, the exercise price may not be less than the fair market value of the underlying stock on the grant date of the option, determined based on a reasonable method using actual when-issued transactions in the stock reported by the over-the-counter market. The taxpayer's nonstatutory stock option failed to meet the requirements of section 409A(a) because the exercise price was less than the applicable fair market value of the underlying stock on the grant date and the terms of the option did not provide for exercise dates that were permissible payment events.
3. The proposed section 409A income inclusion regulations set forth a methodology for calculating the amount of the income inclusion, additional 20% income tax, and additional interest income tax under section 409A(a)(1) on which taxpayers may rely. Those methods for calculating the amount of the income inclusion and the additional 20% income tax are described below. Because calculation of the additional interest income tax must take account of the taxpayer's other tax attributes for the applicable taxable years, advice on calculation of the additional interest income tax will be provided separately.

FACTS

Prior to \_\_\_\_\_ Date, Parent agreed to grant Taxpayer a certain number of restricted shares of Parent's \_\_\_\_\_ common stock and a nonstatutory option (the Option) to purchase a certain number of shares (Option Shares) of the \_\_\_\_\_ common stock. Also prior to \_\_\_\_\_ Date, Parent and Taxpayer executed restricted stock agreement and \_\_\_\_\_ option agreement providing for grant of the restricted stock and the Option under the terms of the Plan. \_\_\_\_\_ the Plan, \_\_\_\_\_ provides for awards of (or based on) Parent's \_\_\_\_\_ common stock. The agreements provide that the grant date of the restricted stock and the Option is \_\_\_\_\_ Date and that the grants are effective on \_\_\_\_\_ Date. The Plan, which was drafted prior to \_\_\_\_\_ Date, provides that the Plan is effective on \_\_\_\_\_ Date.

The option agreement provides that the Exercise Price is the exercise price per Option Share.

The \_\_\_\_\_ provides that Parent's \_\_\_\_\_ common stock would be issued on \_\_\_\_\_ Date, subject to any necessary corporate action.

By written resolution dated one day prior to \_\_\_\_\_ Date, Parent's \_\_\_\_\_ approved \_\_\_\_\_ to grant the restricted stock and the Option. \_\_\_\_\_ . The resolution provides that the Plan, the restricted stock agreement, and the option agreement (recognized to have already been entered into) would be effective on \_\_\_\_\_ Date and that the Exercise Price would be the exercise price per Option Share.

On Day 1, two days prior to \_\_\_\_\_ Date, Parent's \_\_\_\_\_ common stock began trading on an over-the-counter market.

\_\_\_\_\_, trades made on Day 1, Day 2, and Day 3 (\_\_\_\_\_  
Date) were on a "when, as and if issued" (commonly called a "when issued") basis.

The lowest when-issued trading price for Day 1, Day 2, and Day 3 (Day 1 Lowest Price, Day 2 Lowest Price, and Day 3 Lowest Price) was at least \$ \_\_\_\_\_ more than the Exercise Price. On \_\_\_\_\_ Date (Day 3), the lowest when-issued trading price was over \$ \_\_\_\_\_ more than the Exercise Price.

The Plan provides that the fair market value of a share of Parent's \_\_\_\_\_ common stock shall be determined, as of a particular valuation date, by the closing price per share on such date reported by the securities exchange on which the stock is listed. But if the stock is not listed on a securities exchange but is still publicly traded, the Plan provides that the fair market value shall be determined, as of a particular valuation date, by \_\_\_\_\_ on such date reported by an over-the-counter bulletin board.

\_\_\_\_\_. If the \_\_\_\_\_ common stock is not publicly traded, the Plan provides that the fair market value shall be determined by Parent's \_\_\_\_\_.

The option agreement provides that the exercise price per Option Share is the Exercise Price. The Plan and the option agreement are the only documents setting forth the terms of the Option. Neither the Plan nor the option agreement provides for

any other method to determine the exercise price per Option Share based on publicly traded prices of Parent's common stock.

The consideration for the grant of the Option was Taxpayer's provision of future services to Parent. Taxpayer was not required to pay any additional amount in exchange for grant of the Option.

Under the terms of the option agreement, of the Option Shares would vest during Year 1 following the grant date, and an additional of the Option Shares would vest on the next anniversaries of . The option agreement further provides that the vested Option Shares could be exercised at any time from the vesting date until the

Prior to the end of Year 3, Parent declared a dividend per share (Dividend) to be paid to holders of its common stock. For purposes of this advice, it is assumed that, under the circumstances, the Dividend qualifies as a distribution under §1.424-1(a)(3)(ii) and therefore as a corporate transaction for purposes of §1.409A-1(b)(5)(v)(D).

, Parent determined to adjust the portion of the Option that was unvested as of the dividend declaration date by reducing the exercise price per unvested Option Share by the amount of the Dividend. The Adjusted Exercise Price accordingly became the new exercise price per unvested Option Share (Adjusted Share).

the Exercise Price remained the exercise price per Unadjusted Share.

Taxpayer is under exam for Year 3. For purposes of this advice, the statute of limitations on assessments is assumed to have expired for Year 1 and Year 2. By the end of Year 3, all of the Unadjusted Shares ( of the original Option Shares) had vested, and Taxpayer had partially exercised the Option to purchase of the Unadjusted Shares ( of the original Option Shares), with of the Unadjusted Shares ( of the original Option Shares) remaining unpurchased. Some of the Unadjusted Shares (Year 2 Exercised Shares) were purchased during Year 2, and some (Year 3 Exercised Shares) were purchased during Year 3. By the end of Year 3, of the Adjusted Shares ( of the original Option Shares) had vested.

SUMMARY OF TAX CONSEQUENCES

The following is a summary of the tax consequences for Year 3 due to the failure of the Option to meet the requirements of section 409A for Year 3, as described in the following section of this advice, applicable to each tranche of the Option (based on either vesting or purchase). The additional 20% income tax under section 409A(a)(1)(B)(i)(II) for Year 3 (20% Tax) is calculated as the product of .20 and the amount of the section 409A(a)(1)(A)(i) income inclusion for Year 3. Because calculation of the additional interest income tax under section 409A(a)(1)(B)(i)(I) for Year 3 (Interest Tax) must take account of Taxpayer's other tax attributes for Year 1 and Year 2, advice on calculation of the tax will be provided separately.

<u>Option Tranche</u>	<u>Section 409A(a)(1)(A)(i) Income Inclusion</u>	<u>20% Tax</u>	<u>Interest Tax</u>
Shares Vested in Year 1 (Purchased in Year 2 and Year 3)	N/A (included in Shares Purchased in Year 2 and Year 3)	N/A	N/A
Shares Purchased in Year 2 (Vested in Year 1)	N/A	N/A	N/A
Shares Vested in Year 2 (Unpurchased)	Unexercised Unadjusted Amount	Yes	Yes
Shares Purchased in Year 3 (Vested in Year 1)	Exercised Unadjusted Amount (less the option spread included on Taxpayer's Form 1040 for Year 3)	Yes	Yes (regardless of inclusion of any option spread on Form 1040 for Year 3)
Shares Vested in Year 3 (Unpurchased)	Unexercised Adjusted Amount	Yes	Yes
Shares Vesting After Year 3	N/A	N/A	N/A

LAW AND ANALYSIS1. *Issue One – Grant Date of Option*a. *Law*

Section 1.409A-1(b)(5)(vi)(B)(1) provides that the language the "grant date" of a nonstatutory or other stock option, and similar phrases, refers to the date on which the granting corporation completes the corporate action necessary to create the legally binding right constituting the option. And further, the corporate action creating the legally binding right constituting the option is not considered complete until the date on which the maximum number of shares that can be purchased under the option and the

minimum exercise price are fixed or determinable, and the class of underlying stock and the identity of the service provider is designated.

Section 1.409A-1(b)(5)(vi)(B)(1) further provides that, ordinarily, if the corporate action provides for an immediate offer of stock for sale to a service provider, or provides for a particular date on which the offer is to be made, the date of the granting of the option is the date of the corporate action if the offer is to be made immediately, or the date provided as the date of the offer, as the case may be.

Section 1.409A-1(b)(5)(vi)(B)(2) provides that, if the corporation imposes a condition on the granting of an option (as distinguished from a condition governing the exercise of the option), the condition generally will be given effect in accordance with the intent of the corporation.

Section 1.409A-1(b)(5)(vi)(B)(2) also provides that, if the grant of an option is subject to approval by stockholders, the grant date of the option will be determined as if the option had not been subject to such approval. And further, a condition that does not require corporate action, such as the approval of, or registration with, some regulatory or government agency, for example, a stock exchange or the Securities and Exchange Commission, is ordinarily considered a condition upon the exercise of the option unless the corporation clearly indicates that the option is not to be granted until the condition has been satisfied.

*b. Analysis*

Parent and Taxpayer entered into an \_\_\_\_\_ option agreement prior to \_\_\_\_\_ Date providing for the grant of the Option under the terms of the Plan. However, Parent completed the corporate action necessary to provide for Taxpayer's legally binding right to the Option no earlier than one day prior to \_\_\_\_\_ Date, when Parent's \_\_\_\_\_ approved the grant of the Option. Moreover, the option agreement, as approved by \_\_\_\_\_, provides that the grant date of the Option is \_\_\_\_\_ Date and that the grant of the Option is effective on \_\_\_\_\_ Date. The restricted stock agreement under which Taxpayer was granted restricted stock provides for the same treatment. The Plan under which the Option and the restricted stock were granted also provides that the Plan is effective on \_\_\_\_\_ Date.



, providing for the immediate grant of Taxpayer's restricted stock and other awards of (or based on) Parent's common stock, the Plan could be effective no earlier than Date, prior to which no restricted or other shares of the common stock could have been issued.

Accordingly, Parent's approval of the Option did not provide for an immediate grant of the Option, but rather for the grant to be made on a particular date, Date. The fact that the option agreement defines the grant date as Date further indicates that Parent intended for Date to be the grant date of the Option. Moreover, Parent's approval of the Plan and the grant of the Option to be effective on Date

imposed the same condition to the grant of the Option, which is determinative of the grant date in accordance with Parent's intent.

For the foregoing reasons, Date was the grant date of the Option.

## 2. *Issue Two – "When Issued" Market; Section 409A Failure*

### a. *Law*

Section 1.409A-1(b)(5)(i)(A) provides that a nonstatutory stock option to purchase a fixed number of shares of service recipient stock is not treated as a nonqualified deferred compensation plan subject to section 409A (and therefore is treated as exempt from section 409A) if the exercise price is not less than the fair market value of the underlying stock on the grant date of the option and certain other requirements are met. Conversely, if the exercise price is less than such fair market value (or the option provides for a deferral feature or the right to purchase other than service recipient stock), the option is treated as a nonqualified deferred compensation plan subject to section 409A that must meet the initial deferral election and time and form of payment requirements under the section 409A regulations.

A nonqualified deferred compensation plan subject to section 409A(a) must provide, upon adoption of the plan or when otherwise permitted under the section 409A initial deferral election requirements, for a deferred amount to be paid at a time and in a form meeting the section 409A time and form of payment requirements. To satisfy the time and form of payment requirements, the plan must designate that a specified nondiscretionary and objectively determinable deferred amount may be paid only upon a specified (or the earlier or later of certain specified) permissible payment event (or events), such as a specified time or date, death, disability, separation from service, or a change in control event, or a permissible period following the applicable payment event. Such a permissible period must be designated to end no later than the last day of

applicable taxable year of the service provider or, if potentially later, within 90 days following the specified permissible payment event. For a nonstatutory stock option that is treated as a nonqualified deferred compensation plan subject to section 409A(a), the terms of the option must accordingly designate in accordance with the initial deferral election requirements the nondiscretionary and objectively determinable number of shares that may be purchased through full or partial exercise of the option upon a permissible payment event (or the earlier or later of certain permissible payment events) or a permissible period following the applicable payment event.

For purposes of determining the fair market value of service recipient stock underlying a nonstatutory stock option intended to be exempt from section 409A, §1.409A-1(b)(5)(iv)(A) provides that, for stock that is readily tradable on an established securities market, the fair market value of the stock on the grant date of the option is determined based on a reasonable method using actual transactions in the stock as reported by the established securities market. For example, determination of the fair market value may be based on the last sale before or the first sale after the grant, the closing price on the trading day before or the trading day of the grant, or the arithmetic mean of the high and low prices on the trading day before or the trading day of the grant.

Section 1.409A-1(b)(5)(iv)(A) further provides that the fair market value of the stock on the grant date may be determined using an average selling price during a specified period that is within 30 days before or 30 days after the grant date, provided that the program under which the nonstatutory stock option is granted, including a program with a single participant, must irrevocably specify the commitment to grant the option with an exercise price set using such an average selling price before the beginning of the specified period. To satisfy this requirement, §1.409A-1(b)(5)(iv)(A) provides that the service recipient must designate the method for determining the exercise price, including the period over which the averaging will occur, before the beginning of the specified averaging period.

Section 1.409A-1(b)(5)(iv)(B) provides that, for service recipient stock that is not readily tradable on an established securities market, the fair market value of the stock on the grant date of a nonstatutory stock option is determined based on the reasonable application of a reasonable valuation method, taking into consideration events occurring after the date of the calculation that may materially affect the value of the service recipient stock.

Section 1.409A-1(b)(5)(iv)(A) and §1.409A-1(b)(5)(iv)(B) read together imply that if the underlying service recipient stock is readily tradable on an established securities market on the grant date of a nonstatutory stock option, the fair market value of the stock must be determined based on a reasonable method using actual transactions in the stock as reported by the established securities market. This principle is further indicated under §1.409A-1(b)(5)(iv)(B)(3), which provides that a valuation method under §1.409A-1(b)(5)(iv)(A) must be used (and accordingly a valuation method under

§1.409A-1(b)(5)(iv)(B) may no longer be used) if the stock becomes readily tradable on an established securities market.

Section 1.409A-1(k) provides that, for purposes of section 409A, the term “established securities market” means an established securities market as defined under §1.897-1(m).

Section 1.409A-1(b)(5)(vi)(G) provides that, for purposes of section 409A, stock is treated as readily tradable if it is regularly quoted by brokers or dealers making a market in the stock. In explaining §1.409A-1(b)(5)(vi)(G), the preamble to the final section 409A regulations (*72 Fed. Reg. 19,234, 19,240 (April 17, 2007)*) states that the rule was intended to adopt the same standard as that set forth under §1.280G-1, Q&A-6(e). Section 1.280G-1, Q&A-6(e) provides that, for purposes of section 280G, stock is treated as readily tradable if it is regularly quoted by brokers or dealers making a market in the stock. Section 1.280G-1, Q&A-6(f) provides that, for purposes of section 280G, the term “established securities market” means an established securities market as defined under §1.897-1(m).

Section 1.897-1(m) provides that the term “established securities market” means (1) a national securities exchange which is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f), (2) a foreign national securities exchange which is officially recognized, sanctioned, or supervised by governmental authority, and (3) any over-the-counter market. An over-the-counter market is any market reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers which regularly disseminates quotations of stocks and securities by identified brokers or dealers, other than by quotation sheets which are prepared and distributed by a broker or dealer in the regular course of business and which contain only quotations of such broker or dealer.

It is a common practice for new issues of publicly traded stocks and bonds to be traded on a “when, as and if issued” (commonly called a “when issued”) basis days prior to when the issuer actually issues and distributes the security to holders. A when-issued trade is made between a seller and a buyer contingent on actual issuance of the security, after which settlement of the trade is made.

A when-issued market for a security yet to be issued may occur on an over-the-counter market or any other established securities market as defined under §1.897-1(m). Section 703.02 (part 1) of the New York Stock Exchange’s Listed Company Manual provides guidelines applicable to when-issued trading on the Exchange of a security expected to be issued as a stock dividend: “Normally, the Exchange will initiate when issued trading when the percentage of additional stock distributed is 25% or more of the outstanding. There is no fixed date for the commencement of when issued trading, but the Exchange will usually wait until such time as all corporate and official action requisite to the issuance of shares has been taken.”

The Tax Court held that a when-issued trading price on an over-the-counter market indicates the fair market value of a security prior to its issuance. *Frizzelle Farms, Inc. v. Comm.*, 61 T.C. 737 (1974), *aff'd* 511 F.2d 1009 (4<sup>th</sup> Cir., 1975).

*b. Analysis*

Parent's common stock was traded on a when-issued basis on an over-the-counter market on Date (Day 3), the grant date of the Option. The over-the-counter market on which Parent's common stock was traded was an over-the-counter market, and therefore an established securities market, for purposes of §1.897-1(m) because,

, it occurred on an interdealer quotation system through which the stock was regularly quoted by brokers or dealers making a market in the stock. The fact that the common stock traded on an established securities market in anticipation of, and contingent on, its actual issuance does not negate that such when-issued public trading indicated the fair market value of the stock on the applicable trading date. In fact, the trading volumes for on the over-the-counter market were among the highest recorded for the common stock over . Therefore, the common stock is treated for purposes of section 409A as having been readily tradable on an established securities market on the grant date of the Option.

For purposes of meeting the requirements for exemption from section 409A of a nonstatutory stock option for which the underlying stock is readily tradable on an established securities market, the fair market value of Parent's common stock on the grant date of the Option must be determined based on a reasonable method using actual transactions in the stock as reported by the when-issued, over-the-counter market.

The Plan provides that, for stock traded on an over-the-counter market, the fair market value of Parent's common stock shall be determined, as of a particular valuation date, by the on such date reported by an over-the-counter bulletin board. No documents other than the Plan and the option agreement set forth the terms of the Option. Neither the Plan nor the option agreement designates another method for determining the exercise price per Option Share. Therefore, the terms of the Plan for determining the fair market value of the common stock as of a particular valuation date designate the method for determining the applicable exercise price per Option Share for purposes of meeting the requirements for exemption of the Option from section 409A.

The fair market value of a share of Parent's common stock on Date, the grant date of the Option, was higher than the Exercise Price, the exercise price per Option Share under the terms of the option agreement. On Date (Day 3), the lowest when-issued, over-the-counter trading price was

over \$ more than the Exercise Price. Therefore, the on Date is assumed to have been higher than the Exercise Price.

The Option does not meet the requirements under §1.409A-1(b)(5)(i)(A) for exemption from section 409A because the exercise price per Option Share, based on the Exercise Price, was less than the fair market value per Option Share on the grant date of the Option. Because the Option did not comply with the requirements under §1.409A-1(b)(5)(i)(A) to be exempt from section 409A, the Option is treated as a nonqualified deferred compensation plan subject to section 409A(a) from the grant date until the end of the taxable year during which the Option is either fully exercised or expires.

Because the option agreement provides that Option Shares could generally be purchased through exercise of the Option at any time following vesting and before , the terms of the Option do not designate a permissible payment event or a permissible period following such payment event as the only time that a specified number of Option Shares could be purchased. Therefore, the Option failed to meet the requirements of section 409A(a) from the grant date, Date.

### 3. *Issue Three – Income Tax Calculation for Section 409A Failure*

#### *a. Law*

##### Income Inclusion under Section 409A(a)(1)(A)(i)

Section 409A(a)(1)(A)(i) provides that, if at any time during a taxable year a nonqualified deferred compensation plan (I) fails to meet the requirements of paragraphs (2), (3), and (4) of section 409A(a), or (II) is not operated in accordance with such requirements, all compensation deferred under the plan for the taxable year and all preceding taxable years shall be includible in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.

The Treasury Department and the IRS issued proposed regulations under section 409A(a)(1) on December 8, 2008 (*73 Fed. Reg. 74380*), which have not yet been finalized. The proposed regulations propose to add §1.409A-4 to the section 409A regulations. Prop. §1.409A-4 proposes rules on the calculation of the amount includible in income under section 409A(a)(1)(A)(i) and the additional taxes under section 409A(a)(1)(B)(i).

Part V of IRS Notice 2008-115, 2008-52 I.R.B. 1367, provides that, until Prop. §1.409A-4 is finalized, taxpayers may rely on the rules under Prop. §1.409A-4 in calculating the amount of the income inclusion and additional taxes under section

409A(a)(1) for purposes of ensuring that the requirements of section 409A(a)(1) are met.

Prop. §1.409A-4(a)(1)(i) provides that the amount includible in income under section 409A(a)(1)(A)(i) for a service provider's taxable year due to a failure to meet the requirements of section 409A(a) with respect to a plan is the excess (if any) of (A) the service provider's total amount deferred under the plan for the taxable year, including the amount of any payments of amounts deferred under the plan to (or on behalf of) the service provider during the taxable year; over (B) the portion of such amount, if any, that is either subject to a substantial risk of forfeiture (as defined under §1.409A-1(d) and applying Prop. §1.409A-4(a)(1)(ii)(B)) or has been previously included in income (as defined under Prop. §1.409A-4(a)(3)).

Prop. §1.409A-4(b)(6) provides rules for determining the total amount deferred for the taxable year of a section 409A failure under a nonstatutory stock option or other stock right subject to section 409A. Under Prop. §1.409A-4(b)(6), if a stock right remains unexercised and outstanding on the last day of the service provider's taxable year, the total amount deferred under the stock right for the taxable year is the excess of the fair market value of the underlying stock on the last day of the taxable year (determined in accordance with §1.409A-1(b)(5)(iv)) over the sum of the stock right's exercise price plus any amount paid for the stock right. However, if a stock right has been exercised during the service provider's taxable year, the total amount deferred under the stock right for the taxable year is the excess of the fair market value of the underlying stock (determined in accordance with §1.409A-1(b)(5)(iv)) on the date of exercise over the sum of the exercise price of the stock right and any amount paid for the stock right.

Prop. §1.409A-4(a)(2)(i) provides that the portion of the total amount deferred under a plan for a taxable year that is subject to a substantial risk of forfeiture is determined as of the last day of the service provider's taxable year. Therefore, any amount deferred under a plan that remains unvested as of the end of the taxable year of the section 409A failure is not subject to income inclusion under section 409A(a)(1)(A)(i) for the taxable year.

Prop. §1.409A-4(a)(3) provides that an amount has been previously included in income only if the service provider has actually included the amount in income under an applicable Code section for a previous taxable year. Prop. §1.409A-4(a)(3) further provides that, for future taxable years, the amount previously included in income is reduced to reflect any amount that was paid during the taxable year for which the amount was included in income, any amount allocated (under Prop. §1.409A-4(f)) to a payment of an amount included in income under section 409A(a)(1)(A)(i), and any amount deductible (under Prop. §1.409A-4(g)) due to forfeitures or other permanent loss of right to amounts included in income under section 409A(a)(1)(A)(i).

Prop. §1.409A-4(a)(1)(ii) provides that an amount is includible in income under section 409A(a)(1)(A)(i) for a taxable year only if a plan fails to meet the requirements of section 409A(a) during the taxable year. Prop. §1.409A-4(a)(1)(ii) further provides that whether a plan fails to meet the requirements of section 409A(a) during a taxable year is determined independently of whether the plan fails to meet the requirements of section 409A(a) during a previous or subsequent taxable year, except to the extent provided under Prop. §1.409A-4(a)(3). Accordingly, the consequences of a section 409A failure are determined independently for any particular taxable year during which the failure occurs or continues to occur without regard to such consequences affecting any other taxable year. However, the service provider would receive credit (subject to Prop. §1.409A-4(a)(3)) for amounts previously included in income under section 409A(a)(1)(A)(i) due to a section 409A failure under the plan.

Section 409A(c) provides that any amount included in gross income under section 409A(a)(1)(A)(i) is not required to be included in gross income under any other Code section or any other rule of law later than the time provided under section 409A(a)(1)(A)(i). Prop. §1.409A-4(f)(1) accordingly provides that an amount included in income under section 409A(a)(1)(A)(i) that has neither been paid in the taxable year the amount was included in income under section 409A(a)(1)(A)(i) nor served as the basis for a deduction under Prop. §1.409A-4(g)(1) is allocated to payments of amounts deferred under the plan in taxable years subsequent to the taxable year the amount was included in income under section 409A(a)(1)(A)(i).

Prop. §1.409A-4(g)(1) provides that, if a service provider has included an amount in income under section 409A(a)(1)(A)(i), but has not actually received payment of such amount or otherwise allocated the amount under Prop. §1.409A-4(f)(1), the service provider is entitled to a deduction for the taxable year in which the right to the amount is permanently forfeited under the plan's terms or the right to the payment of the amount is otherwise permanently lost.

Prop. §1.409A-4(f)(2) provides that the plan aggregation rules of §1.409A-1(c)(2) apply to the allocation under Prop. §1.409A-4(f)(1) of amounts previously included in income under section 409A(a)(1)(A)(i) to payments made under the plan. Therefore, the service provider is entitled to allocate an amount previously included in income under section 409A(a)(1)(A)(i) to payments of amounts deferred under any aggregated plan.

Prop. §1.409A-4(g)(2) provides that the plan aggregation rules of §1.409A-1(c)(2) apply to determine whether the right to an amount deferred under a plan is permanently forfeited or otherwise lost. Accordingly, if the right to an identified amount deferred under a plan is permanently forfeited or otherwise lost, but an additional amount remains deferred under any aggregated plan, the service provider is not entitled to a deduction under Prop. §1.409A-4(g)(1).

Additional 20% Tax under Section 409A(a)(1)(B)(i)(II)

Section 409A(a)(1)(B)(i)(II) provides that, if compensation is includible in income under section 409A(a)(1)(A)(i) for a taxable year, the income tax imposed is increased by an amount equal to 20% of the compensation that is includible in income. This amount is an additional income tax, subject to the rules governing the assessment, collection, and payment of income tax, and is not an excise tax.

Prop. §1.409A-4(c) provides that an amount includible in income under section 409A(a)(1)(A)(i) for a taxable year is subject to the additional 20% income tax under section 409A(a)(1)(B)(i)(II). Applying Prop. §1.409A-4(a)(1)(i), the amount subject to the additional 20% income tax is the excess (if any) of (A) the total amount deferred under the plan for the taxable year (including the amount of any payments during the taxable year of amounts deferred under the plan); over (B) the portion of such amount, if any, that is either subject to a substantial risk of forfeiture (as defined under §1.409A-1(d) and applying Prop. §1.409A-4(a)(1)(ii)(B)) as of the end of the taxable year or has been previously included in income (subject to Prop. §1.409A-4(a)(3)).

#### Additional Interest Income Tax under Section 409A(a)(1)(B)(i)(I)

Section 409A(a)(1)(B)(i)(I) provides that, if compensation is includible in income under section 409A(a)(1)(A)(i) for a taxable year, the income tax imposed is increased by an amount equal to the amount of interest determined under section 409A(a)(1)(B)(ii). This amount is an additional income tax, subject to the rules governing assessment, collection, and payment of income tax, and is not an excise tax or interest on an underpayment.

Section 409A(a)(1)(B)(ii) provides that the additional interest income tax is determined as the amount of interest at the underpayment rate plus one percentage point on the underpayments that would have occurred had the deferred compensation been includible in gross income for the taxable year during which first deferred or, if later, the first taxable year during which the deferred compensation is not subject to a substantial risk of forfeiture.

Prop. §1.409A-4(d)(1) provides that an amount includible in income under section 409A(a)(1)(A)(i) for a taxable year is subject to an additional interest income tax (premium interest tax) under section 409A(a)(1)(B)(i)(I) and section 409A(a)(1)(B)(ii) equal to the amount of interest at the underpayment rate plus one percentage point on the underpayments that would have occurred had the deferred amount been includible in the service provider's income for the taxable year during which first deferred or, if later, the first taxable year during which the deferred amount is not subject to a substantial risk of forfeiture.

Prop. §1.409A-4(d)(1) further provides that only the amount that is includible in income under section 409A(a)(1)(A)(i) for a taxable year is required to be allocated to determine the premium interest tax, regardless of whether additional amounts were



deferred under the plan in previous taxable years. Applying Prop. §1.409A-4(a)(1)(i), the amount subject to the premium interest tax is the excess (if any) of (A) the total amount deferred under the plan for the taxable year (including the amount of any payments during the taxable year of amounts deferred under the plan); over (B) the portion of such amount, if any, that is either subject to a substantial risk of forfeiture (as defined under §1.409A-1(d) and applying Prop. §1.409A-4(a)(1)(ii)(B)) as of the end of the taxable year or has been previously included in income (subject to Prop. §1.409A-4(a)(3)).

Accordingly, section 409A(a)(1)(B)(ii) and Prop. §1.409A-4(d)(1) require that the amount subject to the premium interest tax for a taxable year be allocated to the prior taxable year (or years) the applicable portion, treated as a hypothetical underpayment, was first deferred and vested. Interest based on a premium interest rate equal to the underpayment rate plus one percentage point is then calculated based on the hypothetical underpayment for each prior taxable year to reflect the time value of the amount of the underpayment when it was first deferred and vested.

Under the calculation method set forth under Prop. §1.409A-4(d)(2), payments, deemed investment or other losses, and amounts previously included in income under section 409A(a)(1)(A)(i) are allocated to amounts deferred and vested under the plan during the earliest taxable year. This results in a reduction of hypothetical underpayments for the taxable year (or years) prior to the taxable year during which the 409A failure occurs. Any deferred amount that is not allocable to a prior taxable year is treated as first deferred in the taxable year during which the section 409A failure occurs and therefore as not subject to the premium interest tax (assuming that the service provider timely includes the amounts in income for such taxable year). As stated in the preamble to Prop. §1.409A-4(d)(2) (*73 Fed. Reg. 74,380, 74,390 (December 8, 2008)*), this calculation method is intended to result in the lowest possible amount of premium interest tax, because deferred amounts includible in income under section 409A(a)(1)(A)(i) would be treated as first deferred and vested in the latest possible taxable years.

Prop. §1.409A-4(d)(3) provides that a hypothetical underpayment allocated to a taxable year prior to the taxable year during which the section 409A failure occurs is treated as an additional cash payment of compensation to the service provider for the year. Prop. §1.409A-4(d)(3) further provides that the hypothetical underpayment is calculated based on the service provider's taxable income, credits, filing status, and other tax information for the taxable year, based on the service provider's original return filed for the year, as adjusted by any examination for the year or any amended return the service provider filed for the year that was accepted by the Commissioner. The hypothetical underpayment must reflect the effect that the additional compensation would have had on the service provider's Federal income tax liability for the year, including the continued availability of any deductions taken, and the use of any carryovers such as carryover losses. Any changes to the service provider's Federal income tax liability for any subsequent taxable year that would have occurred if the

hypothetical underpayment had been included in the service provider's income for a prior taxable year must be taken into account.

Prop. §1.409A-4(d)(4) provides that the amount of premium interest tax on hypothetical underpayments is determined for any prior taxable year by applying the applicable rate of interest under section 6621 plus one percentage point to determine the underpayment interest under section 6601 that would be due for the underpayment as of the last day of the taxable year of the section 409A failure. Prop. §1.409A-4(d)(4) further provides that the total premium interest tax applicable to a section 409A failure is the sum of the separate amounts of premium interest tax on hypothetical underpayments for all prior taxable years for which they exist.

*b. Analysis*

Income Inclusion under Section 409A(a)(1)(A)(i)

Because the Option failed to meet the requirements of section 409A(a), the Option is subject to section 409A(a)(1)(A)(i) and Prop. §1.409A-4(a)(1)(i). Under Prop. §1.409A-4(a)(1)(i), the total amount deferred under the Option at the end of the taxable year of the Section 409A failure, including any payments of deferred amounts made under the Option during the taxable year, is includible in income under section 409A(a)(1)(A)(i) to the extent not subject to a substantial risk of forfeiture as of the end of the taxable year or included in income for a prior taxable year.

The taxable year of the section 409A failure is Year 3, the taxable year under exam. Although the Option had failed to meet the requirements of section 409A(a) from the grant date, for purposes of this advice, the statute of limitations on assessments is assumed to have expired for Year 1 and Year 2. The consequences of the section 409A failure are determined independently for Year 3 without regard to such consequences affecting any other taxable year, except that Taxpayer would receive credit for any amounts included in income under section 409A(a)(1)(A)(i) for a prior taxable year (subject to Prop. §1.409A-4(a)(3)).

No amounts have been included in income under section 409A(a)(1)(A)(i) for any taxable year prior to Year 3 due to the failure of the Option to meet the requirements of section 409A(a).

By the end of Year 3, all of the Unadjusted Shares (      of the original Option Shares) had vested, and Taxpayer had partially exercised the Option to purchase of the Unadjusted Shares (      of the original Option Shares), with      of the Unadjusted Shares (      of the original Option Shares) remaining unpurchased. Some of the Unadjusted Shares (Year 2 Exercised Shares) were purchased during Year 2, and some (Year 3 Exercised Shares) were purchased during Year 3. By the end of Year 3, of the Adjusted Shares (      of the original Option Shares) had vested.

For purposes of this advice, it is assumed that the Option Shares that remained unvested at the end of Year 3 were, under the circumstances, subject to a substantial risk of forfeiture for purposes of section 409A as of the end of Year 3 and therefore not subject to income inclusion under section 409A(a)(1)(A)(i) for Year 3. Such unvested Option Shares include [redacted] of the Adjusted Shares ([redacted] of the original Option Shares). However, because the section 409A failure will continue to occur until the end of the taxable year during which the Option is fully exercised or expires, the deferred amounts applicable to such Adjusted Shares are subject to section 409A(a)(1)(A)(i) beginning with the subsequent taxable year during which they vest.

Compensation related to Taxpayer's purchase of Year 2 Exercised Shares is not subject to section 409A(a)(1)(A)(i) for Year 3 because, under Prop. §1.409A-4(b)(6), it does not constitute an amount deferred (or a payment) under the Option at any time during Year 3. However, compensation related to Taxpayer's purchase of Year 3 Exercised Shares is subject to section 409A(a)(1)(A)(i) for Year 3 because, under Prop. §1.409A-4(a)(1)(i) and Prop. §1.409A-4(b)(6), it constitutes payment of amounts deferred under the Option during Year 3.

Accordingly, the total amount deferred under the Option for Year 3 subject to income inclusion under section 409A(a)(1)(A)(i) for Year 3 is comprised of two components: (1) the portion that was vested and deferred (that is, unexercised and outstanding) at the end of Year 3 and (2) the portion related to payments of amounts deferred under the Option (that is, as the result of exercise) during Year 3. The portion that was vested and deferred at the end of Year 3 includes the (vested) Unadjusted Shares that remained unpurchased at the end of Year 3 (Unexercised Unadjusted Shares) and the Adjusted Shares that had vested but remained unpurchased by the end of Year 3 (Unexercised Adjusted Shares). The portion relating to payments of amounts deferred under the Option during Year 3 includes the Year 3 Exercised Shares.

For purposes of determining the amount includible in income under section 409A(a)(1)(A)(i) related to the portion that was vested and deferred (that is, unexercised and outstanding) at the end of Year 3, under Prop. §1.409A-4(b)(6), the applicable deferred amount is the excess of the fair market value of Parent's [redacted] common stock on the last day of Year 3 (determined in accordance with §1.409A-1(b)(5)(iv)) over the sum of the exercise price and any amount paid for the Option (the "option spread").

Taxpayer did not pay any amount for the Option other than the exercise price per purchased Option Share.

The option spread applicable to each Unexercised Unadjusted Share (Unexercised Unadjusted Spread) is accordingly determined on the basis of the excess of the

(Year 3 Closing Price) over the Exercise Price (the exercise price per Unadjusted Share). Similarly, the option spread applicable to each Unexercised Adjusted Share (Unexercised Adjusted Spread) is determined on the basis of the excess of the Year 3 Closing Price over the Adjusted Exercise Price (the exercise price per Adjusted Share).

The product of the Unexercised Unadjusted Spread and the number of Unexercised Unadjusted Shares is the deferred amount applicable to the Unexercised Unadjusted Shares (Unexercised Unadjusted Amount). Similarly, the product of the Unexercised Adjusted Spread and the number of Unexercised Adjusted Shares is the deferred amount applicable to the Unexercised Adjusted Shares (Unexercised Adjusted Amount). The sum of the Unexercised Unadjusted Amount and the Unexercised Adjusted Amount is the aggregate amount includible in income under section 409A(a)(1)(A)(i) for the portion of the Option that was vested and deferred (that is, unexercised and outstanding) at the end of Year 3.

For purposes of determining the amount includible in income under section 409A(a)(1)(A)(i) related to payments of amounts deferred under the Option (that is, as the result of exercise) during Year 3, under Prop. §1.409A-4(b)(6), the applicable deferred amount is the excess of the fair market value of the Year 3 Exercised Shares (as determined in accordance with §1.409A-1(b)(5)(iv)) on the date of exercise over the sum of the exercise price and any amount paid for the Option (the “option spread”).

Taxpayer partially exercised the Option during Year 3 to purchase, at the Exercise Price, a certain number of Unadjusted Shares (Year 3 Exercised Shares). The option spread per share applicable to the exercise is determined on the basis of the excess of the price per share on the applicable exercise date of Parent’s common stock over the Exercise Price (the exercise price per Unadjusted Share).

The product of the option spread per share and the number of Year 3 Exercised Shares purchased on the exercise date is the deferred amount applicable to the exercise (Exercised Unadjusted Amount) includible in income under section 409A(a)(1)(A)(i) for the portion of the Option related to payment of amounts deferred under the Option (that is, as the result of exercise) during Year 3.

Although the Exercised Unadjusted Amount is subject to income inclusion under section 409A(a)(1)(A)(i), the amount should have been included in Taxpayer’s income on Taxpayer’s Form 1040 for Year 3 because it represents the compensatory amount

that is includible in income under section 83 and §1.83-7 for the taxable year of exercise (and includible on a Form W-2 issued to Taxpayer). However, because it is treated as a vested amount deferred under the Option for Year 3 (no part of which was included in income for a prior taxable year), the Exercised Unadjusted Amount is subject to income inclusion under section 409A(a)(1)(A)(i) for purposes of calculating the additional 20% income tax under section 409A(a)(1)(B)(i)(II) and the additional premium interest income tax under section 409A(a)(1)(B)(i)(I).

Accordingly, the Unexercised Unadjusted Amount, the Unexercised Adjusted Amount, and the Exercised Unadjusted Amount (the sum of which is the Total Deferred Amount) are subject to income inclusion under Section 409A(a)(1)(A)(i) on account of the section 409A failure for Year 3.

#### Additional 20% Tax under Section 409A(a)(1)(B)(i)(II)

Because the Option failed to meet the requirements of section 409A(a) for Year 3, the amount subject to income inclusion under section 409A(a)(1)(A)(i) and Prop. §1.409A-4(a)(1)(i) for Year 3 (Total Deferred Amount) is subject to an additional 20% tax under section 409A(a)(1)(B)(i)(II) and Prop. §1.409A-4(c) for Year 3.

The additional 20% tax for Year 3 is the product of .20 and the Total Deferred Amount (20% Tax Amount). It is not relevant for purposes of calculation of the 20% Tax Amount that any portion of the Exercised Unadjusted Amount may have otherwise been included in income on Taxpayer's Form 1040 for Year 3.

Accordingly, the 20% Tax Amount is an additional income tax under Section 409A(a)(1) due on account of the section 409A failure for Year 3.

#### Additional Interest Income Tax under Section 409A(a)(1)(B)(i)(I)

Because the Option failed to meet the requirements of section 409A(a) for Year 3, the amount subject to income inclusion under section 409A(a)(1)(A)(i) and Prop. §1.409A-4(a)(1)(i) for Year 3 (Total Deferred Amount) is subject to an additional interest income tax (premium interest tax) under section 409A(a)(1)(B)(i)(I) and Prop. §1.409A-4(d) for Year 3.

Because calculation of the premium interest tax must take account of Taxpayer's other tax attributes for the applicable taxable years, advice on calculation of the premium interest tax for Year 3 will be provided separately. It is not relevant for purposes of calculation of the premium interest tax that any portion of the Exercised Unadjusted Amount may have otherwise been included in income on Taxpayer's Form 1040 for Year 3.

Accordingly, the premium interest tax is an additional income tax under Section 409A(a)(1) due on account of the section 409A failure for Year 3.

c. *Summary*

The following is a summary of the amounts subject to income inclusion and additional taxes under section 409A(a)(1) for Year 3 on account of the section 409A failure under the Option for Year 3.

Includible Amounts. For Year 3, the following amounts are includible in Taxpayer's income under section 409A(a)(1)(A)(i) and Prop. §1.409A-4(a)(1)(i) and reportable on Taxpayer's Form 1040 for Year 3:

Unexercised Unadjusted Amount  
Unexercised Adjusted Amount

Potentially Includible Amount. For Year 3, the following amount is includible in Taxpayer's income under section 409A(a)(1)(A)(i) and Prop. §1.409A-4(a)(1)(i) and reportable on Taxpayer's Form 1040 for Year 3; however, the amount is not so includible to the extent that it has already been included on a Form W-2 issued to Taxpayer and reported on Taxpayer's Form 1040 for Year 3:

Exercised Unadjusted Amount

Additional 20% Income Tax. For Year 3, the following amounts are subject to an additional 20% income tax under section 409A(a)(1)(B)(i)(II) and Prop. §1.409A-4(c), which amount (20% Tax Amount) is treated as an additional income tax reportable on Taxpayer's Form 1040 for Year 3:

Unexercised Unadjusted Amount  
Unexercised Adjusted Amount  
Exercised Unadjusted Amount

Additional Interest Income Tax. For Year 3, the following amounts are subject to an additional interest income tax (premium interest tax) under section 409A(a)(1)(B)(i)(I) and Prop. §1.409A-4(d), which amount is treated as an additional income tax reportable on Taxpayer's Form 1040 for Year 3:

Unexercised Unadjusted Amount  
Unexercised Adjusted Amount  
Exercised Unadjusted Amount

Amounts Not Subject to Section 409A(a)(1) Income Inclusion and Additional Taxes. The following amounts are not includible in Taxpayer's income under section 409A(a)(1)(A)(i) and Prop. §1.409A-4(a)(1)(i), not subject to an additional 20% income tax under section 409A(a)(1)(B)(i)(II) and Prop. §1.409A-4(c) and an additional interest income tax under section 409A(a)(1)(B)(i)(I) and Prop. §1.409A-4(d), and not reportable

on Taxpayer's Form 1040, for Year 3; however, the amounts will become so includible in Taxpayer's income, subject to the additional section 409A(a)(1) taxes, and reportable on Taxpayer's Form 1040 for Taxpayer's taxable years during which they vest (or remain unexercised and outstanding):

Deferred amounts applicable to \_\_\_\_\_ of the Adjusted Shares ( \_\_\_\_\_ of the original Option Shares) that remained unvested as of the end of Year 3.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call \_\_\_\_\_ if you have any further questions.

By: \_\_\_\_\_  
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