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# The 409A Hit Parade Continues

**By Christopher A. Karachale • Wood & Porter • San Francisco**

The economy may still be off, but specialists in Code Sec. 409A seem like the ship hands on an Alaskan trawler, working day and night to fill their traps with as many king crabs as they can. All of this as the now ubiquitous section continues to pinch away not only at M&A deals, but nearly every aspect of business transactions. [For prior coverage, *see* Wood, *Fear & Loathing in Code Sec. 409A*, M&A Tax Rep., Dec. 2008, at 3.]

Given that Code Sec. 409A gets its claws on nearly every instance of deferred compensation, it is not just the practitioners who have their boats in this race for the deadliest catch. The IRS has spent the last year trying to keep up with implications of the section's peripatetic influence. Indeed, in the first full week of January, 2010, the IRS has already published yet another tome, in the form of Notice 2010-6.

This Notice is intended to provide methods for taxpayers to voluntarily correct many types of failures to comply with the document requirements applicable under Code Sec. 409A. This latest Notice supplements Notice 2008-113, 2008-2 CB 1305, which was intended to provide procedures to obtain relief from certain failures of nonqualified deferred compensation plans in operation. They are like new toys coming out every 30 days, each one replacing the prior model. That's tough on all of us as parents trying to rein in our Code Sec. 409A bad seed.

## Broad Reach

Of course, it makes sense that the IRS has been forced to disseminate such extensive ameliorative guidance, given the breadth of Code Sec. 409A. Recall that the section applies to:

- Any employment, bonus or compensation agreement that results in the deferral of the taxation of compensation
- Supplemental executive retirement plans (sometimes called SERPs) and other nonqualified retirement arrangements

**ALSO IN THIS ISSUE**

- Restricted stock, phantom stock and performance share plans
- Code Sec. 457(f) plans
- Certain stock appreciation rights
- Many long-term or multi-year bonus or commission programs

That is considerable territory. Plus, once a nonqualified deferred compensation plan is within the clutches of Code Sec. 409A, the deferred compensation can only be paid upon one of the following six events or times:

- The service provider's separation from service
- The service provider becoming disabled
- The service provider's death
- A time or a fixed schedule specified under the plan
- A change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the assets of the corporation
- The occurrence of an unforeseeable emergency

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## Cover of TARP

It should come as no surprise then that Code Sec. 409A was implicated in the Troubled Asset Relief Program (TARP). For better or worse, TARP allowed the Secretary of the Treasury broad leeway to purchase troubled assets from financial institutions. [*See* Section 101(a) of the Emergency Economic Stabilization Act of 2008.]

Sounds easy. The problem was that pursuant to TARP, the federal government was required to approve compensation payments to, and the compensation structure of, certain employees of TARP recipient companies. The employees generally affected were the TARP recipient's senior executive officers and a number (determined by the level of TARP assistance received) of the next most highly compensated employees.

This approval requirement gave rise to a Code Sec. 409A quandary. Indeed, compliance with changes as part of the overall restructuring of a compensation arrangement by the government would often result in delays in payments and possibly acceleration of certain payments that would not comply with Code Sec. 409A(a).

## Peeling TARP Away

Thus, on December 11, 2009, the IRS published Notice 2009-92, IRB 2009-52, 964, providing that the IRS would issue regulations allowing for changes in the time and form of payment of nonqualified deferred compensation to the extent necessary to comply with demands on executives by the federal government pursuant to TARP. In the meantime, the IRS essentially acquiesced to—and made an exception for—the application of certain provisions of Code Sec. 409A on TARP recipients and their senior executives.

## Backdated Stock Options

In the M&A context, the TARP issue was surely not the most interesting manifestation of Code Sec. 409A. Far more intriguing was Generic Legal Advice Memorandum, 2009-006 (July 6, 2009), dealing with the application of Code Sec. 162(m) to backdated and misdated stock options.

GLAM 2009-006 (yes, at the M&A TAX REPORT, we love the GLAM abbreviation) provides yet another example of how Code Sec. 409A's wide application influences other areas of the law. Take deductions for excessive employee remuneration. One of the issues addressed in the GLAM was whether discounted stock options qualify as performance-based compensation under Code Sec. 162(m)(4)(C).

Bear in mind that the $1 million cap on deductions for employee-based remuneration does not apply to qualified performance-based compensation. This includes stock options, provided certain requirements are met. The GLAM concludes that discounted stock options are *not* qualified performance-based compensation under Code Sec. 162(m)(4)(C).

This is so even if, before or after exercise, executives reimburse employers for the discount or the option is "repriced" based on the fair-market value on the actual date of grant. Interestingly, the IRS found itself on the defensive with respect to this repricing issue. Can you guess why?

Code Sec. 409A, of course! Apparently, taxpayers wanted to know why the IRS was allowing taxpayers to reprice options for purposes of Code Sec. 409A, but not Code Sec. 162(m). In the GLAM, the IRS lists the various administrative materials published after 2004, allowing certain transitional relief for nonqualified deferred compensation arrangements, including discounted options.

These include Notice 2005-1 (2005-1 CB 274), Notice 2006-79 (2006-2 CB 763), Notice 2007-86 (IRB 2007-46, 990) and Notice 2008-113 (discussed above). All of them allowed some form of relief for discounted options that were repriced. That seems fair, after all.

Whose ox should be gored? Why, taxpayers wanted to know, were individuals allowed extended relief under the Code Sec. 409A regime with respect to repriced options, while under the Code Sec. 162(m) standard, no such largesse would be permitted?

## Relief Denied

Here, the IRS's words to speak for themselves: "Code Sec. 409A was a new and complex statute, and final regulations had not become effective, and therefore it was appropriate to provide transition relief. By contrast, Code Sec. 162(m) and the regulations thereunder have been in place for many years."

Call me cynical, but I think the mere length of time that a Treasury regulation has been in place is a less than convincing defense. (Indeed, the GLAM earlier concedes that the otherwise august Code Sec. 162(m) regulations do not even provide a standard for determining the grant date of options.)

As with the TARP issue, a more convincing explanation may be that the IRS has not anticipated the full implications the Code Sec. 409A regime. (Who could?) Perhaps it is because Congress continues to pass new and broad financial legislation that inadvertently sets off the 409A tripwire.

Alternatively, maybe the IRS is indeed justified in giving coddled treatment to besieged taxpayers under the 409A rules, despite the fact that such treatment may give rise to inequitable treatment under other Code provisions. In any event, it seems clear that Code Sec. 409A's breadth will continue to affect areas of the Code in ways we cannot anticipate. Like 3-D glasses at your local Cineplex, it's everywhere.

## Watchful Waiting

Barring some extraordinary change, we all know that Code Sec. 409A is here to stay. This is especially true in the M&A arena. It will be interesting to see which piece of legislation or Code section next ends up entangled in this Brobdingnagian section's crab pot.