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**THE REGULATION OF EMPLOYEE STOCK OPTIONS AFTER
CODE SECTION 409A:**

A Proposal for Reform and a Survival Kit for the Interim

by

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**Submitted in partial fulfillment of the requirements of the
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THE REGULATION OF EMPLOYEE STOCK OPTIONS AFTER CODE SECTION 409A: A Proposal for Reform and a Survival Kit in the Interim

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INTRODUCTION

Picture yourself as a general business attorney who has been practicing for decades. A client comes into your office seeking some advice. He has a privately held corporation and wants to give employees and non-employee members of the board of directors an additional incentive to keep the value of the company stock high by aligning their interests more closely with those of shareholders generally. In addition, he would like to use these stock options to reward these individuals, so he would like to give them the opportunity to buy the stock for less

than the fair market value of the shares. So you go ahead and draft up some employee stock options. Other than the discount, they are plain vanilla stock options, with no vesting schedule, exercisable at the discretion of the holder for a period of years.

Congratulations, you've just subjected your client's employees to immediate inclusion of the amount of the spread in gross income, regardless of when they actually exercise the option, giving rise to taxation of up to thirty-five percent. Add to that a twenty percent excise tax, just for good measure. Of course, it will probably be a while before anyone realizes that you screwed up, so interest will be accruing from the date of grant.

What if he didn't even want to issue the options at a discount, but instead at fair market value. He even brings you an independent valuation he had performed a couple years ago. Surely now you would be safe drafting up some plain vanilla options, right? Unfortunately, no luck here either.

Where did you go wrong? You've been doing this for years and this has never happened. You based the options on the same sections of the Internal Revenue Code that you always have, specifically Sections 421 through 424. You even double-checked to make sure they hadn't been amended. In fact, these weren't even drafted as incentive stock options, so they weren't subject to all of the extra requirements in Section 422. So why are you now faced with an unpleasant call to your malpractice carrier? Because you forgot to check in the regulations relating to nonqualified deferred compensation.

If your never would have thought to look there and you feel that scattering rules relating to stock options throughout the 397 pages of recently finalized nonqualified deferred compensation regulations represents a low blow by the IRS, you're not alone. With the enactment of Code Section 409A, practitioners in other areas are increasingly finding that they

have wandered unwittingly into the realm of deferred compensation, a practice area in which it is hard to stay current, even for attorneys practicing exclusively in that area.

It appears that Congress basically eradicated discounted stock options as we knew them, but the majority of practitioners failed to notice because Congress accomplished this task under the guise of pension legislation. Under Section 409A, nonqualified deferred compensation can only be payable upon the occurrence of certain enumerated events. While most stock options are exempt from the application of this section, discounted stock options are not. As a result, if a company wishes to issue a discounted stock option, it essentially must specify at the outset when the option will be exercised. In doing so, the fundamental nature of the option is destroyed by eliminating the holder's discretion over when to exercise the option. Worse yet, many privately-held companies are issuing options at a discount without even realizing it, because their valuation methods are not up to par. This paper explores the recent development of the law in this area and offers suggestions for improvement. In addition, practical advice is provided for working with stock options unless and until the proposed improvements are implemented.

I. BACKGROUND

A. The Fundamentals of Employee Stock Options

As a derivative, a stock option is a “financial contract . . . which is derived from the future value of an underlying asset.”¹ Although derivatives can be quite complex and the strategies employed by those trading in derivatives markets can be mind-boggling, a typical stock option used for equity-based compensation is fairly straight forward. “An option contract confers the right, but not the obligation, to buy . . . a specific underlying instrument at a specific price – the strike or exercise price – up until or on a specific future date – the [expiration] date.”²

1. Nonqualified Stock Options versus Incentive Stock Options

Employee stock options generally take one of two forms: nonqualified stock options (“NSOs”)³ or incentive stock options (“ISOs”).⁴ In order to qualify as an incentive stock option, the option must meet certain requirements outlined in Code Section 422. Nonqualified options are essentially just stock options that do not meet the Code Section 422 requirements for special treatment, and are therefore subject to taxation under Code Section 83.⁵ In addition, if an option states by its terms that it will not be treated as an incentive stock option, that option will be treated as a nonqualified option even if it would otherwise satisfy the requirements of an incentive stock option.⁶

First, incentive stock options can only be issued to employees, who must exercise the option while they are still employed by the corporation or within a certain limited time after termination.⁷ Thus, non-employee members of the corporation’s board of directors are not eligible to receive incentive stock options.⁸ In order to qualify as an incentive stock option, a stock option has to be issued pursuant to a plan that has been approved by shareholders of the corporation within the last ten years.⁹ The plan must specify the number of shares authorized to be issued.¹⁰ Incentive stock options cannot be issued at a discount,¹¹ and are only valid for ten years after the date of grant.¹² In addition, the option must be exercisable, during the option holder’s lifetime, only by the option holder, and may be transferred only through will or probate.¹³ Finally, an individual who owns more than ten percent of the total combined voting power of all outstanding classes of stock is not eligible to receive an incentive stock option.¹⁴

The primary difference between the two types of options from the perspective of the option holder is the tax consequences. Ignoring, for now, the impact of Code Section 409A, the spread on a nonqualified stock option is taxable upon exercise.¹⁵ The aggregate difference

between the fair market value of the underlying shares and the exercise price of the options is treated as compensation and is thus includible as ordinary income.¹⁶ At present the highest tax bracket for ordinary income applicable to individuals is 35%.¹⁷

The spread on incentive stock options, on the other hand, is not taxable upon exercise, but rather is taxable on ultimate disposition of the underlying stock, provided the option holder complies with certain requirements.¹⁸ The most important of these requirements is that the option holder waits a minimum of one year after the date of exercise to sell the stock. In addition, incentive stock options create the potential for capital gains treatment. If the employee waits to sell the underlying stock until the later of (1) two years after the date of grant or (2) one year after the date of exercise, any gain on the sale of the stock is treated as a long-term capital gain.¹⁹ The long-term capital gains rate for taxpayers in the highest individual tax bracket is currently 15%.²⁰

2. American Style Stock Options versus European Style Stock Options

There are two basic styles of stock options: American and European.²¹ An American style option is exercisable, at the discretion of the option holder, at any time prior to its expiration date.²² In contrast, a European style option is exercisable only upon its predetermined expiration date.²³ Because of this distinction, where an American option and a European option are otherwise identical, the American option will be more valuable on account of its comparatively greater flexibility.²⁴ At least prior to the enactment of Code Section 409A, virtually every employee stock option (both nonqualified stock options and incentive stock options) was granted as an American style option.²⁵

B. The Enactment of Code Section 409A

Prior to the enactment of Code Section 409A, nonqualified deferred compensation arrangements were largely governed by the common law principles of the economic benefit doctrine and the doctrine of constructive receipt.²⁶

Under the economic benefit doctrine, amounts become taxable to the employee when they are irreversibly set aside for the employee's benefit.²⁷ Therefore, once the amounts are not subject to a substantial risk of forfeiture, they become taxable to the employee. This doctrine has been codified in Code Section 83 for some time. However, Code Section 83, by its terms, applies to the transfer of "property."²⁸ Because Treasury Regulation Section 1.83-3 defines property as "real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future,"²⁹ most traditional nonqualified deferred compensation plans avoided taxation under Code Section 83 by taking advantage of the "unfunded and unsecured" language.³⁰ Many of these arrangements are structured as "rabbi trusts,"³¹ under which the funds are held in a trust and cannot be taken back by the employer, but are still subject to claims by company's general unsecured creditors in bankruptcy or insolvency.³² "A rabbi trust helps assure employees that their employer will have the liquidity to pay promised benefits . . . although it will not protect them against the employer's insolvency."³³

Stock options are dealt with specifically in Treasury Regulation Section 1.83-7. That regulation provides that Code Section 83(a) will apply to stock options, other than incentive stock options, "if the option has a readily ascertainable fair market value . . . at the time the option is granted."³⁴ These options continue to be subject to Code Section 83 after the passage of Code Section 409A. However, for certain of these options, Code Section 409A will override

the application of Code Section 83, leading to harsh tax consequences and more limited planning opportunities.

More directly affected by the enactment of Code Section 409A is the doctrine of constructive receipt. Almost all individual taxpayers are on the cash method of accounting for tax purposes, meaning that they recognize income when that income is actually received.³⁵ The doctrine of constructive receipt provides an exception to this general premise.³⁶ “In essence, the doctrine of constructive receipt means a taxpayer cannot turn his back on income or, more accurately, the cash method taxpayer who has control over his actual receipt of income must report it, regardless of whether he has actual physical possession of it.”³⁷ This principle is described in more detail in Treasury Regulation Section 1.451-2(a):

Income although not actually reduced to a taxpayer’s possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer’s control of its receipt is subject to substantial limitations or restrictions.³⁸

Prior to the adoption of Code Section 409A, the area of constructive receipt was fleshed out by case holdings and rulings by the IRS, which had evolved into rules that received the general acquiescence of benefits practitioners.³⁹ Several of the provisions of Code Section 409A, including some specifically applicable to stock options, incorporate these principles of constructive receipt developed at common law and administratively. However, some of these principles were altered or even reversed in the process of codification. For instance, “it was commonly accepted that a provision allowing an employee to make a subsequent election to further extend the deferral of benefits would not be taxable under the doctrine of constructive receipt, as long as the subsequent selection was made before the benefits were due to be paid.”⁴⁰

In the context of stock options, this principle would have allowed the employee holding the option to extend the exercise date of the option. However, “while § 409A [was] not technically designed to overrule common law doctrines, the practical effect of the statute’s requirements will be to overrule or limit a number of practices allowed under prior cases and rulings, [including the aforementioned extension provision].”⁴¹

Section 409A was added to the Internal Revenue Code by Section 885 of the American Jobs Creation Act of 2004.⁴² Some have claimed that it represented a congressional overreaction to perceived abuses of nonqualified deferred compensation plans during the Enron scandal.⁴³ Ironically, the tragic losses of the retirement savings of rank-and-file workers at Enron were the result of a blackout period provision prohibiting trades in the company’s *qualified* 401(k) plan, which was over-invested in employer stock.⁴⁴ This disaster may have been accentuated when executives took advantage of early withdrawal provisions in the company’s nonqualified arrangements, but the losses for rank-and-file workers were not caused by these transactions or any other abuse of the company’s nonqualified arrangements.⁴⁵ Ironically though, the events at Enron served as a catalyst for lawmakers to revamp the laws governing nonqualified deferred compensation arrangements.

C. Penalties for Violation of Code Section 409A

The consequences for violation of Code Section 409A have been described as a “draconian penalty regime.”⁴⁶ In general, if an arrangement subject to Code Section 409A fails to meet its requirements, all compensation deferred under the arrangement to that point that is not subject to a substantial risk of forfeiture is immediately includible in gross income.⁴⁷ In addition, the amount that is includible in gross income is subject to an additional twenty percent excise tax.⁴⁸ Finally, interest is due on the amount included in gross income at the underpayment

rate plus one percent, calculated from the point at which the amounts should have first been included in gross income (i.e., the year of the deferral or, if later, the year in which the amounts were no longer subject to a substantial risk of forfeiture).⁴⁹

Although the IRS has provided only limited guidance as to exactly how these amounts should be calculated with respect to stock options,⁵⁰ practitioners can make an educated guess through reasoning by analogy to traditional nonqualified deferred compensation plans. What is relatively certain in this regard is that the amount deferred under a stock option is equal to the amount of the spread, or the excess of the fair market value of the underlying stock over the exercise price on the date of exercise.⁵¹ Therefore, the spread is includible in gross income and subject to the additional twenty percent excise tax.

The methodology for calculating the interest component of the penalties is not as straight forward.⁵² Discounted stock options have a built in spread on the date of grant. Therefore, perhaps interest should be calculated on this spread from the date of grant until the exercise date. On the other hand, these options generally continue to have a spread, and that spread varies over time until the date of exercise. The spread on the date of exercise provides a more accurate representation of the benefit provided to the employee. However, logically, if the spread upon exercise is used, interest should not begin accruing until the date of exercise (which of course would not yield any interest). It is possible that the IRS could require use of the spread upon exercise (which would generally be larger than the spread at the date of grant), but calculate interest upon that spread from the date of grant. A final possibility could involve keeping track of the spread as it increases and decreases from the date of grant until the date of exercise, and calculating interest from each of these valuation dates. Some of these possibilities seem to be

unreasonably punitive and an administrative nightmare, but, then again, so does the rest of Code Section 409A.

Significantly, all plans of the same type are aggregated for Code Section 409A purposes. All deferrals of compensation with respect to an employee under arrangements that constitute “stock rights” are treated as a single plan.⁵³ Therefore, if an employee has income from any one stock option included by reason of Code Section 409A, all amounts deferred under all nonqualified stock options and stock appreciation rights held by that employee become immediately includible in income and subject to the penalties and interest associated with that inclusion.⁵⁴

II. CODE SECTION 409A AS APPLIED TO EMPLOYEE STOCK OPTIONS

There are essentially two ways to avoid the harsh penalties of Code Section 409A. The first is to be exempt from application of its requirements. Arrangements that are not exempt must satisfy all of Code Section 409A’s requirements, both in form and operation. While most stock options are exempt from Code Section 409A, discounted options are not. Furthermore, while it is theoretically possible to draft a discounted option in compliance with Code Section 409A, as a practical matter, an option so drafted would lose much of its value.

A. In General, Discounted Nonqualified Stock Options are not Exempt from Code Section 409A

Under Code Section 409A, any plan that “provides for the deferral of compensation” constitutes a nonqualified deferred compensation plan unless specifically exempted.⁵⁵ “A plan provides for the deferral of compensation if . . . [the employee]⁵⁶ has a legally binding right during a taxable year to compensation that . . . is or may be payable to [the employee] in a later taxable year.”⁵⁷ However, incentive stock options and options granted pursuant to an employee stock purchase plan are deemed not to constitute a deferral of compensation.⁵⁸

Nonqualified stock options are deemed not to provide for a deferral of compensation, and therefore are exempt from the application of Code Section 409A, only if certain requirements are met. First, the exercise price must be at least equal to the fair market value of the underlying stock on the date of grant.⁵⁹ Second, the number of shares available under the option must be fixed on the date of grant.⁶⁰ Third, transfer or exercise of the option must be taxable under Code Section 83 and Treasury Regulation Section 1.83-7.⁶¹ Finally, the option must not contain any other feature providing for the deferral of compensation.⁶² Obviously, discounted nonqualified stock options will fail the first requirement because, by definition, their exercise price will be less than the fair market value of the underlying shares. These discounted options will therefore not be exempt from Code Section 409A.

1. Valuation problems for non-publicly traded companies

These new rules are especially troublesome at privately-held companies. While publicly-traded companies face a new set of rules if they choose to issue discounted options, they benefit from being able to identify, with relative certainty, when they have breached this arena. Privately-held companies, on the other hand, may be issuing stock options subject to Code Section 409A without realizing it.

This is because one of the main triggers for the application of Code Section 409A is the discount on a stock option.⁶³ Determining whether the stock option has been issued at a discount requires measuring the fair market value of the underlying stock.⁶⁴ This is a relatively straight forward process for a publicly traded company. However, the “rule is unduly burdensome and restrictive for private companies. . . .”⁶⁵

The regulations issued pursuant to Code Section 409A provide that for a company whose stock that is readily tradable on an established securities market, fair market value may be

determined by “any . . . reasonable method using actual transactions in such stock as reported by such market.”⁶⁶ Permitted valuations include, but are not limited to: “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, [and] the arithmetic mean of the high and low prices on the trading day before or the trading day of the grant.”⁶⁷ Thus, publicly-traded companies are given the freedom to use any reasonable method using readily available actual market data, and are provided with several simple examples of what will suffice.

Contrast this with privately-held companies, who are given a facts-and-circumstances standard. “[I]n the case of [company] stock that is not readily tradable on an established securities market, the fair market value of the stock . . . means a value determined by the reasonable application of a reasonable valuation method.”⁶⁸ Notice that, at first blush, this sounds approximately the same as the “any . . . reasonable method”⁶⁹ standard for publicly-traded companies. However, instead being followed by a list of simple calculations deemed to be reasonable, the standard for privately-held companies is followed by a laundry list of factors that will be considered in a facts-and-circumstances test,⁷⁰ which include:

The value of tangible and intangible assets of the corporation, the present value of anticipated future cash-flows of the corporation, the market value of stock or equity interest in similar corporations and other entities engaged in trades or businesses substantially similar to those engaged in by the corporation the stock of which is to be valued, the value of which can be readily determined through nondiscretionary, objective means (such as through trading prices on an established securities market or an amount paid in an arm’s length private transaction), recent arm’s length transactions involving the sale or transfer of such stock or equity interests, and other relevant factors such as control premiums or discounts for lack of marketability and which the valuation method is used for other purposes that have a material economic effect on the service recipient, its stockholders, or its creditors.⁷¹

The facts-and-circumstances standard, together with this plethora of factors considered, make it virtually impossible for a privately-held company to determine, with any degree of certainty, the fair market value of its stock and whether the exercise price on its stock options is discounted. Therefore, it is difficult for a privately-held company to navigate this “maze of parameters and restrictions”⁷² and emerge confident that its stock options are not subject to the rigid requirements of Code Section 409A.

To make matters worse, a valuation process will not be considered reasonable unless it takes into account “*all* available information material to the value of the corporation.”⁷³ Furthermore, an earlier valuation (even if reasonable when calculated) will no longer be considered reasonable if this material information changes.⁷⁴ Even something as seemingly benign as the resolution of a material lawsuit would be considered a change in material information that would invalidate the calculation.⁷⁵ Finally, regardless of whether any change in material information has occurred, no valuation more than twelve months old will be considered reasonable.⁷⁶ Not only do these requirements make the facts-and-circumstances test harder to satisfy, they require frequent (at least annual) valuations which could prove prohibitively expensive for smaller privately-held companies.

Perhaps because it realized how onerous of a task meeting this facts-and-circumstances test would be, the Department of Treasury provided three valuation methods which will be granted a presumption of reasonableness.⁷⁷ The first is an independent appraisal performed within the last twelve months.⁷⁸ While this presumptively reasonable valuation technique provides certainty to privately-held companies, it is likely to be significantly more expensive than performing the valuation in house and will still have to be performed at least annually. The price of an initial valuation by an independent appraiser has been estimated at \$10,000 to

\$15,000.⁷⁹ Presumably, the price would decrease in future years, but would still represent a significant cash outlay, which “will make this option cost-prohibitive for smaller to medium-sized companies.”⁸⁰

The second presumptively reasonable valuation method is a formula based on the tax principles governing the valuation of shares subject to nonlapse restrictions, which must be consistently applied for all purposes, both compensatory and noncompensatory.⁸¹ A “nonlapse restriction,” defined in Treasury Regulation Section 1.83-3(h), is a “permanent limitation on the transferability of property which will require the transferee of the property to sell, or offer to sell, such property at a price determined under a formula, and which will continue to apply to and be enforced against the transferee or any subsequent holder. . . .”⁸² For instance, a right of first refusal at a price determined under a formula, would be a nonlapse restriction.⁸³ For shares subject to a nonlapse restriction, the price determined under the formula will ordinarily be considered to be the fair market value of the shares, particularly if the formula is based upon book value, a reasonable multiple of earnings, or a reasonable combination of the two.⁸⁴ This valuation method appears to be of very limited usefulness, as it would be relatively rare for the stock underlying a stock option to have such nonlapse restrictions.

The third valuation method carrying a presumption of reasonableness is essentially just a written valuation made in good faith taking into account all of the factors for the facts and circumstances determination discussed above, performed by an individual qualified to perform such a calculation.⁸⁵ While this third method is similar to the first, note that it allows for the valuation to be performed by an insider at the company, which would likely result in significant cost savings. In order to be considered qualified, the individual would generally have five years of pertinent experience and would be the type of person on whose advice another reasonable

individual would rely with respect to such a valuation.⁸⁶ While this quasi-safe harbor appears, at first blush, to be a gaping hole in the valuation rules, it is of little practical significance because it applies only to the “illiquid stock of a start-up corporation.”⁸⁷ Thus, this third presumptively reasonable valuation method may not be used by ongoing enterprises. In addition, even for illiquid stock of start-up corporations, this third method may not be used if a change in control is expected to occur within the next 90 days or an initial public offering (IPO) is expected in the next 180 days.⁸⁸

As indicated above, incentive stock options are also prohibited from being issued at a discount.⁸⁹ Curiously though, the determination of fair market value for purposes of issuing incentive stock options is satisfied by a good faith effort.⁹⁰ Incentive stock options need only satisfy this lax standard while nonqualified stock options are held to a much more rigorous scrutiny. There does not appear to be any policy reason that would justify imposing two very different standards for the same exemption from Code Section 409A

2. Limited Exemptions from the Code Section 409A

There are two exemptions which will allow a limited number of discounted nonqualified stock options to avoid the strictures of Code Section 409A. Though these exemptions are very valuable for certain other arrangements,⁹¹ they are of limited usefulness in the context of stock options. These exemptions are the short-term deferral rule and the grandfather rule.

a. The Short-Term Deferral Rule

The short-term deferral rule provides an exemption for amounts paid within two and one-half months of the close of the taxable year of the employee or employer (whichever ends later) in which it is no longer subject to a substantial risk of forfeiture.⁹² If both the employee and employer are on the calendar year, this means that the amounts must be received by March 15 of

the year after the year in which they are deemed deferred. In the context of discounted stock options, this means that the employee may be permitted to exercise his or her option by March 15 of the year subsequent to the year of issuance, without triggering the application of Code Section 409A. As a practical matter, a stock option with such a short time frame would do little to align the goals of the employee with the goals of the stockholders, and thus would fail in one of its essential functions.

b. Arrangements Grandfathered from the Application of Code Section 409A

Amounts deferred and vested prior to January 1, 2005 are grandfathered from the application of Code Section 409A.⁹³ This can be a very powerful exemption from Code Section 409A, shielding any stock options issued and vested prior to January 1, 2005 from the application of that Code Section. However, its utility is limited by two factors.

First, because only options earned and vested prior to January 1, 2005 are protected, the exemption is useless as a prospective planning tool. Second, this grandfathered status will be lost on any options that are modified after October 3, 2004.⁹⁴ Thus, for example, the window for the exercise of these options may not be extended without losing grandfathered status. In fact, while this practice was quite commonplace prior to the enactment of Code Section 409A, it is all but prohibited under the new regime. In a post-409A world, extension of the exercise date of an in-the-money⁹⁵ option will result in the option being treated as “having had an additional deferral feature from the original date of grant, and therefore will be treated as a plan providing for the deferral of compensation from the original grant date.”⁹⁶ Recall that this will cause the option to be subject to Code Section 409A, even if the option was not issued at a discount.⁹⁷ In addition, unless the extension is made one year before the option could have been exercised and (in most cases) prohibits the exercise of the option for at least five years, the extension also causes the

stock option to fail Code Section 409A's requirements and brings its taxes and penalties into play.⁹⁸ Thus, the grandfather rule exempting certain arrangements from Code Section 409A has limited applicability, particularly from the perspective of a practitioner seeking to engage in strategic prospective planning.

B. Drafting Nonqualified Stock Options to be Compliant with Code Section 409A

Failure to find an exemption, however, does not necessarily mean that the employee will have a tax problem. It is, at least in theory, possible to draft these discounted stock options so that they are in compliance with Code Section 409A. As a practical matter, however, doing so significantly decreases their value.

Code Section 409A has three overarching requirements that must be met in order to avoid its penalties. First, distributions⁹⁹ may not be made other than on account of certain enumerated events.¹⁰⁰ Second, the time or schedule of distributions may not be accelerated.¹⁰¹ Third, certain requirements must be met with regard to initial and subsequent elections to defer compensation.¹⁰² While the second and third requirements have a somewhat limited application in the stock option arena,¹⁰³ the first requirement is the equivalent of an anvil dropped on the traditional structure of a stock option. This requirement fundamentally alters the operation of options to which it applies.

Code Section 409A(a)(2) requires that distributions from nonqualified deferred compensation plans occur only on account of: (1) separation from service, (2) disability, (3) death, (4) a specified time (or pursuant to a fixed schedule), (5) a change of ownership or effective control of the company, or (6) an unforeseeable emergency.¹⁰⁴ Because the event upon which or the date on which the option will be exercised must be fixed at the outset, much of the value of the option is destroyed. In essence, Code Section 409A forces discounted employee

stock options to be structured as something closer to European style options. Certain provisions (discussed in Section IV below) relax the strict timing requirements of Code Section 409A to some extent and allow for certain planning opportunities, but the effect is still to create a slightly relaxed version of the European style option that is less valuable to the employee than an American style option.¹⁰⁵ “[T]he benefit of a stock option versus other forms of equity compensation has always been the ability of the employee to decide when to exercise, and thus dictate his/her tax event.”¹⁰⁶

III. MODIFICATION OF THE 409A REGULATIONS TO PERMIT THE CUSTOMARY EXERCISE OF OPTIONS

Treasury Regulation Section 1.409A-3(b) should be amended by adding the following new sentence after the second sentence of that Section: “Notwithstanding the foregoing, a stock option will be deemed to provide payment upon a permissible payment event if the stock option satisfies paragraph (i)(1)(vi) of this section.”

In addition, subsection (vi) of Treasury Regulation Section 1.409A-3(i)(1) should be redennominated at subsection (vii), and the following new subsection should be added as subsection (vi):

“(vi) Stock Rights. A stock option that fails to meet the requirements of § 1.409A-1(b)(5)(i)(A) because it fails to satisfy paragraph (1) of that section meets the requirements of a specified date or fixed schedule of payments with respect to amounts received as a result of exercise of that option if the following conditions are met:

(1) The stock option is exercisable until an expiration date that is fixed as of the date such option was granted.

(2) The stock option does not fail to meet either paragraph (2) or (3) of § 1.409A-1(b)(5)(i)(A).

(3) The stock option does not represent deferred compensation otherwise subject to section 409A, which has been structured as a stock option to avoid the application of that section.”

There are a variety of policy reasons that favor such a change. To begin with, the IRS already had effective tools to regulate discounted stock options prior to the enactment of Code Section 409A. The Service could police abusive arrangements using the economic benefit principles codified in Code Section 83 and the common law doctrine of constructive receipt developed through the administrative rulings of the Service and the decisions of courts.¹⁰⁷ If the Service wished to reverse its position on certain issues (for instance, the pre-409A position of allowing subsequent elections to further extend the deferral of benefits¹⁰⁸), such a reversal could have been accomplished by far less drastic means than a total overhaul of nonqualified deferred compensation law, which suddenly now encompasses stock options.

Some may concede that discounted stock options should be taxed to a greater extent than stock options issued at fair market value. However, the penalties for violation of Code Section 409A are so extreme as to make discounted stock options basically worthless when structured as an American option. It may be admitted that discounted stock options were not a particularly favored instrument for compensating executives even before the passage of Code Section 409A, due to, among other factors, the effect on shareholder perception and changes in accounting rules. However, while these considerations would discourage companies from issuing discounted stock options, those discounted stock options could still be issued if the company felt they were needed notwithstanding the negative implications. Furthermore, these types of

considerations represent the proper avenues through which to address the issuance of such options, rather than using extreme taxation as a tool to effectively preclude two parties from entering into a transaction, depriving them of their freedom to contract.

Moreover, the valuation rules put smaller, privately-held employers at a distinct disadvantage to larger, publicly-traded companies. Unless these smaller, privately-held employers are willing to make significant cash outlays for annual independent valuations or to roll the dice with a facts-and-circumstances standard, they cannot be sure whether they will be deemed to have issued their options at a discount.¹⁰⁹ This lack of certainty is likely to have an adverse impact on the smaller, privately-held companies' ability to attract talent, because, as mentioned above, the adverse tax consequences resulting from a violation of Code Section 409A fall squarely on the shoulders of the employee.¹¹⁰

IV. DRAFTING OPTIONS FOR 409A COMPLIANCE IN THE ABSENCE OF REGULATORY MODIFICATION

Unless and until the modifications suggested by the preceding section are implemented, discounted qualified options are largely dead as we know them today. However, there are still a few ways to draft employee stock options in compliance with Code Section 409A without totally destroying their practicality.

A. Options Exercisable Upon a Change of Control

As a practical matter, many stock options are exercised upon a change in control; such was the case even prior to the enactment of Code Section 409A.¹¹¹ As previously discussed, a employee stock option can be drafted to comply with Code Section 409A by limiting exercise of the option to certain predetermined permissible events.¹¹² The problem is that not all of these permissible distributable events are well-suited in the context of employee stock options.

However, one permissible event that is particularly well suited is a change of ownership or effective control of the company.

Under the 409A final regulations a change in control includes “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”¹¹³

An arrangement is permitted to designate all, or any combination of, these change in control events as a distributable event. However, the regulations require that these events be objectively determinable.¹¹⁴

Under the final 409A regulations, a change in ownership occurs on the date of a transaction wherein one person or group acquires stock in the corporation that causes that person or group to possess more than half of the total fair market value or total voting power of the corporation.¹¹⁵ However, if the parties so desire, an arrangement is permitted to substitute any ownership threshold over fifty percent for these purposes.¹¹⁶

A change in effective control occurs in the same circumstances as a change in ownership, except that the ownership threshold required is only thirty percent.¹¹⁷ Again, the parties are free to specify any ownership threshold over that thirty percent for these purposes.¹¹⁸ In addition, a change in effective control is deemed to occur on “[t]he date a majority of members of the corporation’s board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation’s board of directors before the date of the appointment or election. . . .”¹¹⁹ As might be expected, the parties are permitted to require more than a simply majority for these purposes.¹²⁰

A change in ownership of a substantial portion of the corporation’s assets is defined as the date when any person or group acquires at least forty percent of the value of the assets of the

corporation (without regard to liabilities).¹²¹ Of course, if they so desire, the parties may specify any threshold exceeding forty percent.¹²² In the case of a change in ownership, there are also certain rules regarding transfers between related parties to determine whether a change in ownership has actually occurred.¹²³

Substantial additional flexibility is provided by Treasury Regulation Section 1.409A-3(d), which provides that “a payment is treated as made upon the date specified under the plan . . . if the payment is made at such date or a later date within the same taxable year of the [employee]. . . .”¹²⁴ Thus, an employee stock option could give the holder until the end of the year in which the change in control occurs to exercise. An argument could be made that an option could be drafted to give the option holder until the later of the end of the taxable year or the fifteenth day of the third month after the change in control. However, Treasury Regulation Section 1.409A-3(d) also requires that such a “later of” provision not give the employee the direct or indirect option to designate the taxable year of payment. This is another situation where provisions that make sense as applied to traditional nonqualified deferred compensation plans do not translate well into the world of stock options. Because a stock option vests the holder with discretion over when to exercise, inclusion of such “later of” language would inherently give the employee the impermissible option to designate the taxable year of payment.

Finally, because a qualifying change in control is a permissible distributable event,¹²⁵ a stock option subject to this restriction on exercise can be immediately vested without triggering Code Section 409A’s adverse tax consequences.

B. Options Subject to Vesting Provisions

Although the use of the above approach allows for immediate vesting, strategic use of vesting provisions provides another approach to structuring options to comply with the

requirements of Code Section 409A. Recall that amounts deferred in an arrangement subject to Code Section 409A are not taxable until they are not longer subject to a substantial risk of forfeiture.¹²⁶ “Compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services. . . .”¹²⁷ In other words, a vesting schedule will satisfy the substantial risk of forfeiture requirement.

By containing a fixed exercise date or schedule of exercise dates that corresponds with the date or dates the options become vested, the options would satisfy Code Section 409A’s distribution-related requirements through being exercisable at a specified time (or pursuant to a fixed schedule).¹²⁸ Here too, the drafter of the option should take advantage of the additional flexibility provided by Treasury Regulation Section 1.409A-3(d), to give the holder until the end of the year in which the option vests in which to exercise it.

A similar alternative approach could be used involving the short term deferral rule.¹²⁹ If the option requires exercise by the 15th day of the third month after it vests, the option never actually provides for a deferral of compensation pursuant to the short term deferral rule discussed above.¹³⁰ Therefore, such an option would be exempt from Code Section 409A. However, this approach is not likely to be used often since the previous tactic will almost always provide the option holder with more flexibility in terms of when to exercise. Just as with the aforementioned change in control strategy, it would not be permissible to give the employee until the later of the last day of the taxable year in which the option vests or the fifteenth day of the third month after the option vests, because it gives the employee the impermissible option to designate the taxable year of payment.¹³¹

CONCLUSION

With regard to stock options, Code Section 409A represents a dangerous trap for the unsuspecting practitioner. This far-reaching and punitive Code Section was passed in an all-too-frequent Congressional overreaction to perceived abuses, the primary impetus in this case being the Enron scandal. Though Code Section 409A applies by its terms to “nonqualified deferred compensation,” through it Congress quietly but effectively eradicated discounted stock options as we know them today. No longer can discounted stock options be exercised up until a certain date, as would have been the case for an American style option.

At first glance, this may not appear to be particularly significant because discounted stock options were used infrequently, as compared to other types of options. However, it is important to note that incentive stock options may become subject to Code Section 409A as well if they are subsequently modified in a manner deemed impermissible under Code Section 409A. In addition, small, privately-held companies may inadvertently issue nonqualified stock options at a discount because of the difficulty of ascertaining the fair market value of their shares. Under the final Code Section 409A regulations, these small, privately-held companies will either need to take their chances that their valuation will hold up in a facts and circumstances determination, or invest a significant sum of money to achieve some certainty. These considerations may deter small, privately-held companies from issuing stock options at all, which is unfortunate, since these are precisely the types of companies that cannot afford massive paychecks for executives and need these types of compensation structures to attract talent. Even if a small, privately-held company is willing to venture into this treacherous territory, potential talent may not be so brave, since they, rather than their employers, will shoulder the punishment of this Draconian tax regime.

For these reasons, and others discussed above, the Internal Revenue Service should amend the Final Regulations issued pursuant to Code Section 409A to provide that discounted stock options will be deemed to be payable upon a “specified date or fixed schedule of payments” with respect to amounts received as a result of exercise of that option if the stock option is exercisable until an expiration date that is fixed as of the date such option was granted. This simple change would allow for the normal (i.e., American style) operation of stock options subject to Code Section 409A. Additionally, this would alleviate, to a substantial degree, the disproportionate burden that Code Section 409A has placed on small, privately-held companies.

However, unless and until these modifications are made, practitioners will be best served by treading carefully through the final regulations, which are incredibly voluminous and interwoven with cross-references. The first step should be to see if the stock option in question might be exempt from the application of Code Section 409A. This category will include incentive stock options (in the absence of impermissible modifications) and nonqualified stock options meeting certain requirements (the most prominent of which is that the option not be issued at a discount). There are also two other exemptions of little practical usefulness: stock options providing only for a short-term deferral and stock options grandfathered from the application of Code Section 409A. If the stock option in question is not exempt from the application of Code Section 409A, the practitioner’s next step should be to determine whether the situation in question presents business circumstances that might suggest it would actually make sense to draft the stock option in compliance with the requirements of Code Section 409A. Such circumstances may be presented when the primary motivation is to protect an employee from a change in control, or where, for some reason, the employee is satisfied with the ability to exercise the option within a year of the option vesting. If none of this fits, the practitioner’s only

remaining move is to draft the stock option as a European style option, exercisable on a date fixed at issuance.

¹ REUTERS, AN INTRODUCTION TO DERIVATIVES 11 (1999).

² *Id.* at 73 (1999). The type of option described in the text accompanying this note is known as a “call option.” *Id.* It should be noted that options can also be designed as the right, but not the obligation, to sell at a predetermined strike price until or upon a certain future date, in which case the option is known as a “put option.” Because put options are not provided as incentives to employees (indeed to do so would be counterintuitive), these options are not dealt with in this paper. *See also* MICHAEL S. WILLIAMS & AMY HOFFMAN, FUNDAMENTALS OF THE OPTIONS MARKET 11 (2001).

³ In the context of Code Section 409A, these options are referred to as “*nonstatutory* stock options,” perhaps to avoid any confusion with the term “nonqualified deferred compensation.” The two terms are synonymous. In all other settings they appear to be referred to as nonqualified stock options, *see, e.g.*, Treas. Reg. § 1.83-7, thus this paper will refer to such options as “nonqualified stock options.”

⁴ ALAN B. UNGAR & MARK T. SAKANASHI, YOUR EMPLOYEE STOCK OPTIONS 25-26 (2001).

⁵ I.R.C. §§ 421(a); 422(a).

⁶ I.R.C. § 422(b).

⁷ Treas. Reg. § 1.421-1(h).

⁸ Treas. Reg. § 1.421-1(h).

⁹ I.R.C. §§ 422(b)(1)-(2).

¹⁰ I.R.C. § 422(b)(1).

¹¹ I.R.C. § 422(b)(4). *But see infra* text accompanying notes 89-90.

¹² I.R.C. § 422(b)(3).

¹³ I.R.C. § 422(b)(5).

¹⁴ I.R.C. § 422(b)(6).

¹⁵ UNGAR & SAKANASHI, *supra* note 4, at 41.

¹⁶ *Id.*

¹⁷ I.R.C. § 1(c).

¹⁸ UNGAR & SAKANASHI, *supra* note 4, at 41.

¹⁹ I.R.C. § 422(a)(1).

²⁰ I.R.C. § 1(h).

²¹ OPTIONS: ESSENTIAL CONCEPTS AND TRADING STRATEGIES 32 (The Options Inst.: The Educ. Div. of the Chi. Bd. Options Exch. ed., 1990). There are also other “exotic options,” such as Bermuda options or Asian options. These exotic option types are beyond the scope of this paper. It should also be noted that the geographic origin of a particular option is wholly irrelevant to the style of that option. *Id.*

²² *Id.*

²³ *Id.*

²⁴ *Id.*

²⁵ John M. Abowd & David S. Kaplan, *Executive Compensation: Six Questions That Need Answering*, THE J. OF ECON. PERSP. 145, 150 (1999).

²⁶ Steven J. Arsenault & W.R. Koprowski, *The Policy of Regulating Deferral: A Critique in Light of Internal Revenue Code Section 409A*, 7 HOUS. BUS. & TAX L.J. 243, 247-50 (2006); Vanessa A Scott, *Fallacies of Presumption: Unpacking the Impact of the Section 409A Proposed Regulations on Stock Appreciation Rights Issued by Privately-Held Companies*, 59 TAX LAW. 867, 869 (2005) (“For decades, constructive receipt and economic benefit were the touchstones of the Service’s nonqualified deferred compensation regulatory scheme.”).

²⁷ Arsenault & Koprowski, *supra* note 26, at 247.

²⁸ I.R.C. § 83(a).

²⁹ Treas. Reg. § 1.83-3(e).

³⁰ Section 409A also substantially reshaped the rules applicable to the funding of nonqualified deferred compensation arrangements. Those portions of the Code Section and the corresponding Treasury Regulations are beyond the scope of this paper.

³¹ These trusts are so-named because the first opinion letter issued by the IRS on the issue was requested by a synagogue.

³² A. Thomas Brisendine, E. Thomas Veal, & Elizabeth Drigotas, Tax Management Compensation Planning Portfolio 385-4th, *Deferred Compensation Arrangements*.

³³ *Id.*

³⁴ Treas. Reg. § 1.83(a).

³⁵ J. MARTIN BURKE & MICHAEL K. FRIEL, *TAXATION OF INDIVIDUAL INCOME* 617 (7th ed. 2004).

³⁶ Arsenault & Koprowski, *supra* note 26, at 249.

³⁷ BURKE & FRIEL, *supra* note 35, at 618.

³⁸ Treas. Reg. § 1.451-2(a).

³⁹ Arsenault & Koprowski, *supra* note 26, at 249.

⁴⁰ *Id.*

⁴¹ *Id.* at 250.

⁴² Pub. Law 108-357, 118 Stat. 1418.

⁴³ See, e.g., Richard J. Bronstein, *Rethinking Code Section 409A*, TAXES, March 2006, at 179, 183. Ironically, much of the tragedy of Enron was caused by standard and even required qualified plan provisions. See Arsenault & Koprowski, *supra* note 26, at 258-59.

⁴⁴ Arsenault & Koprowski, *supra* note 26, at 257-59 (2006).

⁴⁵ *Id.*

⁴⁶ Letter from American Benefits Council, et. al., to Kevin Brown, Donald Korb, and Eric Solomon (dated August 29, 2007); see also A. William Caporizzo & Kimberly B. Wethly, *Structuring Stock Options and Severance Payments after Section 409A: Practical Advice for Venture-backed Companies*, VENTURE CAPITAL REVIEW (Spring 2006), at 21.

⁴⁷ I.R.C. § 409A(a)(1)(A)(i).

⁴⁸ I.R.C. § 409A(a)(1)(B)(i)(II).

⁴⁹ I.R.C. §§ 409A(a)(1)(B)(i)(I), 409A(a)(1)(B)(i)(I)(ii).

⁵⁰ See IRS Announcement 2007-18 (describing the calculations of Code Section 409A taxes for the limited purpose of participating in a compliance resolution program for discounted stock options exercised in 2006). Treasury Regulation Section 1.409A-4, “Calculation of income inclusion,” has been reserved by the Service for future guidance.

⁵¹ See IRS Announcement 2007-18.

⁵² IRS Announcement 2007-18 provides for calculation of interest in the following manner for purposes of a compliance resolution program for discounted stock options exercised in 2006:

For purposes of [the] program, the amount of the interest tax equals the amount of interest at the underpayment rate plus 1% on the underpayment of Federal income tax that would have occurred had the portion of the amount deferred under the stock right as of December 31, 2005, that was not subject to a substantial risk of forfeiture . . . as of December 31, 2005, been includible in gross income as of December 31, 2005. For this purpose, the amount deferred under the stock right as of December 31, 2005 equals the excess of the fair market value of the underlying stock on December 31, 2005 over the sum of the exercise price and any other amount paid by the employee for the stock right. . . . For purposes of determining the applicable interest, the underpayment is treated as due on April 17, 2006, and the interest runs from that date through the earlier of April 17, 2007 or the date the further submission is sent to the IRS with payment.

⁵³ Treas. Reg. § 1.409A-1(c)(2)(i)(H).

⁵⁴ Treas. Reg. § 1.409A-1(l).

⁵⁵ Treas. Reg. § 1.409A-1(a)(1).

⁵⁶ Under the parlance of Code Section 409A and the Treasury Regulations thereunder, this individual would be referred to as a “service provider.” For simplicity and ease of reading, this note will refer to this individual as an “employee.” However, it is important to note that a “service provider” need not be an employee or even a natural person. See Treas. Reg. § 1.409A-1(f). While independent contractors are generally excluded from the application of Code Section 409A, this exclusion does not apply to a member of the board of directors of a corporation. Treas.

Reg. § 1.409A-1(f)(2)(i)(A). Nonqualified stock options are often issued to non-employee directors. In fact, those individuals are probably more likely to receive discounted stock options than any other group.

⁵⁷ Treas. Reg. § 1.409A-1(b)(1).

⁵⁸ Treas. Reg. § 1.409A-1(b)(5)(ii).

⁵⁹ Treas. Reg. § 1.409A-1(b)(5)(i)(A)(1).

⁶⁰ Treas. Reg. § 1.409A-1(b)(5)(i)(A)(1).

⁶¹ Treas. Reg. § 1.409A-1(b)(5)(i)(A)(2).

⁶² Treas. Reg. § 1.409A-1(b)(5)(i)(A)(3).

⁶³ Treas. Reg. § 1.409A-1(b)(5)(i)(A)(1).

⁶⁴ Treas. Reg. § 1.409A-1(b)(5)(i)(A)(1).

⁶⁵ Scott, *supra* note 26, at 881.

⁶⁶ Treas. Reg. § 1.409A-1(b)(5)(iv)(A).

⁶⁷ Treas. Reg. § 1.409A-1(b)(5)(iv)(A).

⁶⁸ Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(1).

⁶⁹ Treas. Reg. § 1.409A-1(b)(5)(iv)(A).

⁷⁰ Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(1).

⁷¹ Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(1).

⁷² Scott, *supra* note 26, at 882.

⁷³ Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(1) (emphasis added).

⁷⁴ Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(1).

⁷⁵ Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(1).

⁷⁶ Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(1).

⁷⁷ Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(2).

⁷⁸ Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(2)(i). This appraisal must meet the requirements for employee stock ownership plan (“ESOP”) appraisals under Code Section 401(a)(28)(C), and the regulations thereunder. *Id.*

⁷⁹ Scott, *supra* note 26, at 881 (citing Jill Andresky Fraser, *Private Company Stock*, INC. MAGAZINE, May 2000, available at <http://www.inc.com/magazine/20000501/18710.html>).

⁸⁰ Scott, *supra* note 26, at 881.

⁸¹ See Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(2)(ii).

⁸² Treas. Reg. § 1.83-3(h).

⁸³ Treas. Reg. § 1.83-3(h).

⁸⁴ Treas. Reg. § 1.83-5(a), as made applicable to I.R.C. § 409A by Treas. Reg. 1.409A-1(b)(5)(iv)(B)(2)(ii).

⁸⁵ See Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(2)(iii).

⁸⁶ See Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(2)(iii).

⁸⁷ Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(2)(iii).

⁸⁸ Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(2)(iii).

⁸⁹ *Supra* note 11 and accompanying text.

⁹⁰ I.R.C. § 422(c)(1).

⁹¹ For example, the short-term deferral rule is particularly useful for shielding severance agreements from Code Section 409A.

⁹² Treas. Reg. § 1.409A-1(b)(4)(i)(A).

⁹³ Treas. Reg. §§ 1.409A-6(a)(1)(i); 1.409A-6(a)(2).

⁹⁴ Treas. Reg. § 1.409A-6(a)(1)(i).

⁹⁵ An in-the-money option refers to a call option where the fair market value of the stock exceeds the strike price. OPTIONS, *supra* note 21, at 132.

⁹⁶ Treas. Reg. § 1.409A-1(b)(5)(v).

⁹⁷ See *supra* note 62 and accompanying text.

⁹⁸ Treas. Reg. § 1.409A-2(b)(1).

⁹⁹ In the case of a stock option, exercise of the option is the equivalent of a “distribution.”

¹⁰⁰ I.R.C. § 409A(a)(2); Treas. Reg. § 1.409A-3.

¹⁰¹ I.R.C. § 409A(a)(3).

¹⁰² I.R.C. § 409A(a)(4); Treas. Reg. § 1.409A-2.

¹⁰³ At least for the purposes of this paper.

¹⁰⁴ I.R.C. § 409A(a)(2); Treas. Reg. § 1.409A-3(a).

¹⁰⁵ See *supra* Section I.A.2.

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- ¹⁰⁶ Caporizzo & Wethly, *supra* note 46.
- ¹⁰⁷ *See supra* Section I.B.
- ¹⁰⁸ *See supra* text accompanying note 40.
- ¹⁰⁹ *See supra* Section II.A.1.
- ¹¹⁰ *See supra* Section I.C.
- ¹¹¹ Caporizzo & Wethly, *supra* note 46, at 24
- ¹¹² *See supra* Section II.B.
- ¹¹³ Treas. Reg. § 1.409A-3(i)(5)(i).
- ¹¹⁴ Treas. Reg. § 1.409A-3(i)(5)(i).
- ¹¹⁵ Treas. Reg. § 1.409A-3(i)(5)(v)(A). “[P]ersons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation.” Treas. Reg. § 1.409A-3(i)(5)(v)(B).
- ¹¹⁶ Treas. Reg. § 1.409A-3(i)(5)(v)(A).
- ¹¹⁷ Treas. Reg. § 1.409A-3(i)(5)(vi)(A)(1).
- ¹¹⁸ Treas. Reg. § 1.409A-3(i)(5)(vi)(A)(1).
- ¹¹⁹ Treas. Reg. § 1.409A-3(i)(5)(vi)(A)(2).
- ¹²⁰ Treas. Reg. § 1.409A-3(i)(5)(vi)(A)(2).
- ¹²¹ Treas. Reg. § 1.409A-3(i)(5)(vii)(A).
- ¹²² Treas. Reg. § 1.409A-3(i)(5)(vii)(A).
- ¹²³ Treas. Reg. § 1.409A-3(i)(5)(vii)(B).
- ¹²⁴ Treas. Reg. § 1.409A-3(d).
- ¹²⁵ *See* I.R.C. § 409A(a)(2); Treas. Reg. § 1.409A-3(a).
- ¹²⁶ *See* I.R.C. § 409A(a)(1)(A)(i)(II).
- ¹²⁷ Treas. Reg. § 1.409A-1(d)(1).
- ¹²⁸ *See* I.R.C. § 409A(a)(2); Treas. Reg. § 1.409A-3(a).
- ¹²⁹ *See supra* Section II.A.2.a.
- ¹³⁰ Treas. Reg. § 1.409A-1(b)(4).
- ¹³¹ *See supra* notes 124-125 and accompanying text.