



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

October 13, 2005

OFFICE OF  
CHIEF COUNSEL

Number: **INFO 2005-0202**  
Release Date: 12/30/05  
CONEX-147244-05/CC:TEGE:EB:EC  
UIL: 409A.00-00

The Honorable J. Dennis Hastert  
U.S. House of Representatives  
Washington, DC 2051 5

Attention: Chris Sarley

Dear Mr. Hastert:

This letter is in response to your inquiry, dated September 8, 2005, on behalf of your constituent, . wrote to you about the impact of section 409A of the Internal Revenue Code (the Code) on his control of his financial assets and our position in recent taxpayer guidance on the application of section 409A to stock appreciation rights.

### **The Enactment of Section 409A of the Code**

The Congress added section 409A to the Code as section 885 of the American Jobs Creation Act of 2004, Pub. Law No. 108-357, 118 Stat. 1418. The law provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are includible in gross income to the extent they are not subject to a substantial risk of forfeiture and were not previously included in gross income, unless the taxpayer meets certain requirements. The law also includes rules applicable to certain trusts or similar arrangements associated with nonqualified deferred compensation, where such arrangements are outside of the United States or are restricted to the provision of benefits in connection with a decline in the financial health of the sponsor. (Section 409A of the Code).

believes that section 409A violates his financial freedom and prohibits him from directing his financial assets in ways that allow him to maximize the financial benefit, minimize tax consequences, adjust to market changes, and react to personal financial needs. The law contains explicit rules explaining how taxpayers can defer compensation without incurring an immediate and additional tax liability, including rules about the timing and manner of initial elections to defer compensation, the timing and manner of payments of deferred compensation, and how to change the time or form of a scheduled payment before receiving the payment.

The legislative history on section 409A states the following about the reasoning underlying the adoption of the provision:

The Congress was aware of the popular use of deferred compensation arrangements by executives to defer current taxation of substantial amounts of income. Many nonqualified deferred compensation arrangements had developed which allowed improper deferral of income. Executives often used arrangements that allowed deferral of income, but also provided security of future payment and control over amounts deferred. For example, nonqualified deferred compensation arrangements often contained provisions that allowed participants to receive distributions upon request, subject to forfeiture of a minimal amount (i.e., a “haircut” provision).

The Congress was aware that since the concept of a rabbi trust was developed, techniques had been used that attempted to protect the assets from creditors despite the terms of the trust. For example, the trust or fund would be located in a foreign jurisdiction, making it difficult or impossible for creditors to reach the assets.

While the general tax principles governing deferred compensation were well established, the determination whether a particular arrangement effectively allowed deferral of income was generally made on a facts and circumstances basis. There was limited specific guidance with respect to common deferral arrangements. The Congress believed that it was appropriate to provide specific rules regarding whether deferral of income inclusion should be permitted.

The Congress believed that certain arrangements that allow participants inappropriate levels of control or access to amounts deferred should not result in deferral of income inclusion. The Congress believed that certain arrangements, such as offshore trusts, which effectively protect assets from creditors, should be treated as funded and not result in deferral of income inclusion. [Staff of Joint Comm. on Taxation, 109<sup>th</sup> Cong., General Explanation of Tax Legislation Enacted in the 108<sup>th</sup> Congress 469 (Comm. Print 2005).]

Subject to certain transitional rules, section 409A generally is effective for deferrals of compensation occurring on or after January 1, 2005.

### **Notice 2005-1 – Initial Taxpayer Guidance Under Section 409A**

On December 20, 2004, we issued Notice 2005-1 [2005-2 I.R.B. 274 (published as modified on January 6, 2005)], as the initial taxpayer guidance on section 409A. Notice 2005-1 defined nonqualified deferred compensation for purposes of section 409A, so that taxpayers could know which types of arrangements section 409A covered. In addition, Notice 2005-1 provided certain transition relief, some that the statute directed

us to provide and some that we believed was necessary to provide taxpayers time and flexibility to adapt to the new Code provision.

has questioned certain statements in Notice 2005-1 about the application of section 409A to stock appreciation rights. Stock appreciation rights generally involve arrangements under which an employee or other service provider is granted the right to the payment of an amount equal to the appreciation on a predetermined number of shares of stock. For example, an employer may grant an employee a stock appreciation right on 500 shares of stock. If the stock appreciates by \$1, and the employee exercises the right, the employee would have the right to a \$500 payment.

Stock appreciation rights are often economically similar to stock options. The legislative history indicates that Congress did not intend section 409A to apply to the grant of an option on employer stock with an exercise price that is equal to or greater than the fair market value of the underlying stock on the date of grant, if the arrangement does not include a deferral feature (other than the option holder's right to exercise the option in the future). H.R. Conf. Rep. No. 108-755, at 735 (2004). Based on this language in the legislative history, taxpayers questioned whether the exclusion of certain stock options from coverage under section 409A would apply to stock appreciation rights.

Notice 2005-1, Q&A-4(d) extended the exclusion from coverage under section 409A to certain stock appreciation rights that we felt most closely resembled stock options. This included only stock appreciation rights on employer stock where such stock was traded on an established securities market and the payment upon exercise could only be made in stock (not in cash). Accordingly, stock appreciation rights on employer stock that was not traded on an established securities market could be subject to taxation under section 409A.

### **Recently Issued Proposed Regulations**

We received many comments criticizing our position on the application of section 409A to stock appreciation rights. In particular, some argued that the application of section 409A to stock appreciation rights issued by non-publicly traded corporations, but not to rights issued by publicly traded corporations, created an unfair advantage for publicly traded corporations. This was particularly true, they argued, because many non-publicly traded corporations could not issue stock to employees, and thus they did not have the alternative of issuing stock options that would be excluded from potential taxation under section 409A of the Code.

We considered all of these comments in formulating the recently issued proposed regulations under section 409A. See 70 Fed. Reg. 57930 (Oct. 4, 2005). The proposed regulations would exclude from coverage under section 409A stock appreciation rights that are substantially similar to stock options that meet the exclusion requirements. This exclusion applies regardless of whether the stock appreciation rights are issued on stock traded on an established securities market, and regardless of whether the employer settles the stock appreciation right in stock or cash.

I hope this information is helpful to  
me at \_\_\_\_\_, or

.

. If you have further questions, please call  
(ID# \_\_\_\_\_) of my staff at

Sincerely,

Nancy J. Marks  
Associate Chief Counsel/Division Counsel  
(Tax Exempt & Government Entities)