Recent Compensation-Related Tax Developments: Three Chief Counsel Advice Memoranda Address Non-Compliant Deferred Compensation, IPO Stock Options and ISOs

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This spring, the Office of the Chief Counsel of the Internal Revenue Service (IRS) released three Chief Counsel Advice (CCA) memoranda regarding a variety of compensatory tax issues. Specifically, the memoranda address:

- whether deferred compensation plan non-compliance can be corrected without adverse tax consequences in the year of vesting;
- the permissible exercise price of stock options granted upon the closing of an initial public offering (IPO); and
- the tax effect of a merger on stock acquired upon the exercise of an incentive stock option (ISO).

Notably, the first two CCA memoranda discussed below address issues arising under Section 409A of the Internal Revenue Code (the "**Code**"), which governs the treatment of nonqualified deferred compensation arrangements, and may be an indication of possible increased IRS audit activity in this area.

CCA memoranda are not binding and may not be used or cited as precedent; however, they are instructive in providing insight into how the IRS interprets and applies the relevant provisions of the Code.

Ability to Correct Deferred Compensation Plan Non-Compliance in the Year of Vesting

On May 1, 2015, the IRS released **CCA Memorandum 201518013**, addressing an employer's ability to correct a Section 409A non-compliant deferred compensation arrangement in the year in which the amount subject to the arrangement vests.

Issue. If an arrangement does not comply with Section 409A of the Code, does a correction made prior to the vesting date of such arrangement avoid income inclusion and other adverse tax consequences under Section 409A where the vesting occurs later that same year?

Background. An employer entered into an agreement with one of its executives pursuant to which the executive's right to receive a retention bonus would cliff-vest on the third anniversary of the execution date of the agreement if the executive remained employed on such date. The retention bonus was generally payable in two equal installments on the first and second anniversaries of the vesting date of the bonus, but the agreement gave the employer the discretion to pay the full retention bonus in a single lump sum on the first anniversary of the vesting date. The employer's discretion to accelerate the payment of the second installment violated the time and form of payment requirements of Section 409(A)(3) of the Code, which generally prohibit an employer's ability to accelerate deferred compensation. As such, on a date in the third year following the execution date of the retention agreement (*i.e.*, in the year in which the bonus was scheduled to vest), but before the date on which the retention bonus actually vested, the employer amended the agreement to eliminate its discretion to accelerate the bonus.

Analysis. The Office of the Chief Counsel concluded that, although the amendment removed the employer's impermissible discretion, because the bonus was vested as of the end of the year in which the correction was made, the full retention bonus was includible in the executive's income for that year (*i.e.*, not when the amounts were actually paid) and was subject to further adverse consequences under Section 409A of the Code.

In reaching this conclusion, the Office of the Chief Counsel cited to Section 409A(a)(1)(A)(i) of the Code (quoted below) and noted that the correction of a compliance failure during a taxable year with respect to an amount that vests during such taxable year results in income inclusion under Section 409A, "regardless of whether the failure is corrected during the same taxable year but before the substantial risk of forfeiture lapses."

> "If at any time during a taxable year a nonqualified deferred compensation plan (I) fails to meet the requirements of section 409A(2), (3) and (4) or, (II) is not operated in accordance with such requirements [(section 409A failure)], all compensation deferred under the plan for the taxable year and all preceding taxable years shall be includible in the service provider's gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income." (emphasis added in the CCA memorandum.)

The Office of the Chief Counsel also noted that the proposed income inclusion regulations under Section 409A of the Code[1] would similarly be unavailable to support the taxpayer's position. Consistent with Section 409A(a)(1)(A)(1) of the Code, a failure to comply with Section 409A at any time during the taxable year triggers income inclusion and the extent to which such arrangement is vested as of the end of such year is then relevant in determining the amount that is then includible. Correction of a failure with respect to an arrangement that is not subject to a substantial risk of forfeiture at all times during the taxable year is ineffectual to avoid inclusion under Section 409A, even if such correction occurs prior to the time at which the substantial risk of forfeiture lapses.

The Office of the Chief Counsel did not address whether the correction would have been effective had it occurred under the voluntary correction procedure set forth in IRS Notice 2010-6 for Section 409A documentary failures; although the facts do not provide enough detail, presumably, the arrangement could have been corrected without adverse Section 409A consequences if it were amended at least 12 months prior to the date on which the employer could have exercised the impermissible discretion. In addition, the CCA memorandum does not address the possibility of amending a compliant unvested deferred compensation arrangement that would remain unvested by year-end, a practice that many practitioners believe is permitted by the Section 409A regulations, so long as its use is not abusive.

Determination of Permissible Exercise Price of Stock Options Granted on the Closing Date of an IPO

On May 22, 2015, the IRS released **CCA Memorandum 201521013**, addressing the application of Section 409A of the Code to certain nonqualified stock options granted in connection with an IPO. While the CCA Memorandum has been heavily redacted and the underlying facts are therefore difficult to discern with precision, it appears that a corporation undergoing an IPO granted nonqualified stock options on the date of closing of the IPO, with an exercise price equal to the IPO price that was set on the pricing date of the IPO.

Issue. For purposes of Section 409A of the Code, what is the fair market value of service recipient stock underlying a nonqualified stock option, where, at the time of the grant, the stock is traded on a when-issued, over-the-counter market?

[1] The proposed income inclusion regulations provided that deferred compensation is includible in income in a taxable year if a failure exists at any time during such taxable year. *See* **Internal Revenue Bulletin No. 2008-51 (December 22, 2008)**.

Background. It appears that a corporation undergoing an IPO agreed, on the pricing date for the IPO, to grant nonqualified stock options to certain of its employees, with such grant to be effective on the closing date of the IPO. The exercise price for the nonqualified stock options was a specified price (while the CCA memorandum does not indicate what this price was, it was presumably equal to the price per share established on the pricing date for the shares to be sold in the IPO). The price per share of the corporation's stock on the closing date for the IPO (which the Office of the Chief Counsel concluded, for purposes of Section 409A of the Code, was the grant date of the nonqualified stock options), based on the prices at which such stock was trading on a when-issued, over-the-counter market, was higher than the exercise price set by the corporation for the nonqualified stock options.

Analysis. A stock option is exempt from the requirements of Section 409A of the Code if, among other requirements, the option is granted with an exercise price that is at least equal to the fair market value of a share of the corporation's stock on the date of grant. Stock options that are granted with an exercise price that is less than the fair market value of a share on the date of grant (also known as "discount options") are subject to Section 409A of the Code, meaning that the employee would be subject to a 20% tax (in addition to ordinary income tax) and other adverse tax consequences when the discount option vests or, in certain cases, is exercised.

In its analysis of options granted on the date of an IPO, the Office of the Chief Counsel focused on the appropriate method for determining the fair market value of a share of a corporation's stock and determined that the over-the-counter market on which the corporation's shares of stock were traded on the date of grant was an established securities market for purposes of Section 409A of the Code, even though such trading occurred on a when-issued basis.[2] The CCA memorandum then concluded that, in order to be exempt from Section 409A of the Code, stock options granted on (or contingent on) the closing date of the IPO must be granted with an exercise price that is at least equal to the fair market value of the stock on such date, which price might exceed the per share price of the shares sold in the IPO, as evidenced by when-issued trading.

Therefore, if a corporation wishes to grant stock options in connection with its IPO, it could do so by granting stock options on:

- the pricing date of the IPO with an exercise price that is at least equal to the IPO price; or
- the closing date of the IPO with an exercise price that is at least equal to the price per share of the corporation's stock on such date, recognizing that the price of the stock could rise in the intervening time between pricing and closing.

Tax Effect of Merger on Stock Acquired upon the Exercise of an ISO

On May 8, 2015, the IRS released **CCA Memorandum 201519031**, addressing the tax effect on stock acquired by an employee through the exercise of an ISO (or ISO stock) where such stock is exchanged in a merger.

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[2] For purposes of determining the fair market value of a share of a corporation's stock, Treas. Reg. § 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 date of grant of the option is determined based on a reasonable method using actual transactions in the stock as reported by the established securities market. In addition to any other reasonable valuation method, Treas. Reg. § 1.409A-1(b)(5)(iv)(A) provides that the fair market value of a share of a corporation's common stock that is readily tradable on an established securities market may be determined using one of the following valuation methods (among others): the last sale price before the date of grant, the closing price on the trading day before the date of grant, the arithmetic mean of the high or low prices on the trading day before the date of grant, or an average selling price during a period of 30 days or less.

An ISO is a qualified stock option that satisfies the requirements of Section 422 of the Code. Unlike with a nonqualified stock option, an employee recognizes no taxable income on the exercise of an ISO, and the tax treatment of the stock acquired on exercise depends on whether or not such stock is disposed of by the employee within the statutorily required holding period of such stock.[3]

Issue. Is there a "disposition" within the meaning of Section 424(c)(1) of the Code of stock acquired pursuant to the exercise of an ISO when the stock is converted into acquirer stock and other consideration pursuant to an acquisition that does not qualify as a "reorganization" under Section 368(a) of the Code?

Background. On July 1, 2011, Corporation X grants an ISO to an employee. On December 30, 2011, the employee exercises the ISO and shares of Corporation X are transferred to the employee. On January 3, 2012, Corporation Y acquires Corporation X through a reverse-subsidiary merger, in which each share of Corporation X stock is exchanged for a share of Corporation Y stock. The memorandum describes two different scenarios for the conversion of the stock:

- In Scenario 1, each share of stock of Corporation X is converted into one share of Corporation Y stock with a value of $25 and $1.50 in cash. The merger in Scenario 1 qualifies as a "reorganization" under Section 368(a)(1) of the Code.
- In Scenario 2, each share of stock of Corporation X is converted into one share of Corporation Y stock with a value of $16.50 and $10 in cash. The merger in Scenario 2 does not qualify as a reorganization.

Given the dates involved, in both scenarios, the conversion of Corporation X stock into Corporation Y stock and cash occurs during the statutory holding period set forth in Section 422(a)(1) of the Code.

Analysis. Section 424(c)(1) of the Code provides that a "disposition" of ISO stock generally includes any sale, exchange, gift or transfer of legal title to the stock, but it excludes, among other things, the exchange of ISO stock to which Section 354 of the Code (relating to the exchange of stock in a reorganization) applies. In other words, ISO stock that is exchanged in a merger that qualifies as a reorganization (*i.e.*, Scenario 1) will not be considered disposed of for purposes of Section 424(c)(1) of the Code and, as such, the employee has the opportunity to continue to satisfy the statutory holding requirements and recognize capital gain on the disposition of his or her ISO stock.

However, ISO stock that is exchanged in a merger that does not qualify as a reorganization (*i.e.*, Scenario 2) will be considered to have been disposed of. Given the dates involved, the disposition will constitute a disqualifying disposition and, on the date of the exchange, the employee will be required to include in gross income the entire gain from the exchange, with a portion of such gain being treated as ordinary income.

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[3] Under Section 422(a)(1) of the Code, an employee will recognize capital gain on a disposition of the ISO stock if the employee holds the stock until the later of (i) the date that is two years from the date of grant of the ISO and (ii) the date that is one year from the date on which the stock was transferred to the employee upon exercise of the ISO. Failure to satisfy the holding requirements will generally require the employee to recognize ordinary income in the year of the disposition of the stock, and the employer will be entitled to a corresponding deduction.

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