

## VESTING OF DEFERRED COMPENSATION: WHEN WORDS ARE MORE TAXING THAN DEEDS

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In this article the authors explore the sweeping consequences of the narrow vesting concept under the deferred compensation rules of Internal Revenue Code section 409A. Their goal is both theoretical and practical. They compare vesting under section 409A with that under section 83 and conclude that, paradoxically, the naked promise is often taxed before the funded one. The new vesting concept thus unsettles longstanding principles of income receipt and even of tax accounting. The practical result, according to the authors, is that employers might prefer to run their promises through section 83 instead of section 409A for its more favorable tax treatment.

definition: sections 402(b), 403(c), 457(f), and 3121(v).<sup>1</sup> Yet for vesting under section 409A, Treasury has fashioned a new definition, one that overlaps with the definition under section 83, but is significantly narrower. Unlike section 83, section 409A does not recognize many conditions as sufficient to defer vesting, including contingent events other than some business-related contingencies; noncompete agreements and other nonservice conditions; and extensions of vesting periods. As a result, compensation may vest for section 409A purposes before it would vest for section 83 purposes.

The narrow definition of vesting under section 409A creates unexpected problems for many common forms of deferred compensation, including typical employment contracts, reimbursement agreements, tax gross-up agreements, golden parachutes, and other executive severance pay packages. Employers will find that many kinds of contingent promises are considered vested and subject to section 409A — in fact, in violation of section 409A and giving rise to taxation and penalties. That consequence can arise even if they are still forfeitable and might never pay, because contingent on events, that might never happen. Perversely, for purposes of defining vested arrangements covered by the statute's grandfather protection, the regulation writers have chosen to use not the narrow definition of vesting under section 409A, but the broader one under section 83. That interpretation narrows the category of payments eligible for grandfather protection.

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### I. Background — Section 409A

The statutory definition of vesting under section 409A is nearly identical to that under section 83, which governs compensatory transfers of property. Until now, Treasury has used the vesting principles of section 83 and regulations under section 83 as the exclusive source of vesting law for all other sections with the same statutory vesting

<sup>1</sup>Treas. reg. section 31.3121(v)(2)-1(e)(3) (vesting under section 83 and the regulations thereunder govern vesting under section 3121(v)(2)); Treas. reg. section 1.403(c)-1(a) (whether employee's rights are vested is defined under Treas. reg. section 1.83-3(b)). See, e.g., LTRs 9713014, Doc 97-8914, 97 TNT 61-33 (whether pay is vested under section 457(f) is determined under section 83 regulations); 9723022, Doc 97-16522, 97 TNT 110-54 (similar); 9211037 (Dec. 17, 1991) (similar); 200321002, Doc 2003-12732, 2003 TNT 101-21 (similar). That is appropriate and follows from the long-standing rule of statutory construction that identical words used in different parts of the same law are intended to have the same meaning. *Commissioner v. Keystone Consolidated Industries*, 508 U.S. 152, 159, Doc 93-5920, 93 TNT 111-11 (1993); *Sorenson v. Sec. of Treasury*, 475 U.S. 851, 860 (1986); *Atlantic Cleaners & Dyers, Inc. v. United States*, 286 U.S. 427, 433 (1932). *Keystone* specifically holds that the code must be given "as great an internal symmetry and consistency as its words permit."

There is one silver lining, however, which this article will explore in detail: The difference between the narrow definition of vesting under section 409A and the broad one under section 83 may create planning opportunities for employers willing to make use of the difference.

## II. Why Vesting Is Important Under Section 409A

As under section 83, a promised payment is not vested under section 409A if the payment is subject to a "substantial risk of forfeiture." When the risk of forfeiture lapses, the promise vests. The concept of vesting has four important functions under section 409A.

### **The narrow definition of vesting under section 409A creates unexpected problems for many common forms of deferred compensation.**

First, vesting is used to determine whether an arrangement is deferred compensation for purposes of section 409A. That role arises from the reticulated definition of deferred compensation in the section 409A proposed regulations. Deferred compensation is generally defined as a "legally binding right" to receive payment in a later year.<sup>2</sup> But a special "short-term deferral" rule provides that an amount is generally not deferred compensation if paid within the first 2½ months of the year after the year in which it vests.<sup>3</sup> If no vesting event is specified, the vesting year for purposes of the 2½ month rule is the year in which the legally binding right arises.<sup>4</sup> Thus, identifying the vesting date is the first step in determining whether or not an amount payable in a later year is deferred compensation. If an amount is paid within 2½ months after the year it vests, it is not deferred compensation and is not subject to section 409A. If paid thereafter, it is deferred compensation and must jump through section 409A's difficult or even impossible hoops.

Second, if deferred compensation fails section 409A, the vesting date establishes the date it is first taxable under section 409A and also the starting date for measuring the throwback-type interest penalty.<sup>5</sup>

Third, the proposed regulation provides that the occurrence of a vesting event is a permitted payment trigger. Section 409A(a)(2) provides that deferred compensation may be paid only on separation from service, death, disability, a specified time (or according to a fixed schedule), a change in control as permitted by regulations, or an unforeseeable emergency. Proposed regulations broaden that list to include vesting events. For example, consider a plan providing that amounts will vest on the earlier of five years of service or when the employer goes public, and further providing that

amounts will pay out one year after they vest. Under the proposed regulations, the employer's going public is a good section 409A vesting condition,<sup>6</sup> even though it is not a permitted distribution trigger.<sup>7</sup> Accordingly, one of the plan's two alternate payout dates — one year after the employer goes public — is not on its face pegged to a permitted section 409A payout trigger. Yet the proposed regulation provides that, because it is a vesting event, the employer's going public is a good payout trigger under the rule permitting payments at a specified time or under a fixed schedule.<sup>8</sup>

The above three uses of the vesting concept all use the special section 409A definition of vesting. In addition, vesting plays a fourth significant role in section 409A: Promises of deferred compensation that vested before 2005 are not subject to section 409A, but rather are grandfathered. Significantly, the definition of vesting for the grandfather rule is different from the vesting rule used elsewhere in section 409A. Amounts are grandfathered only if vested as defined under the more expansive definition of section 83, meaning they might vest *later* than for section 409A purposes.<sup>9</sup> That has the unexpected effect of making many arrangements unexpectedly not vested for section 83 purposes and thus not grandfathered — and yet already vested for section 409A purposes and thus already subject to section 409A. The unwelcome and harsh consequences of that are explored at the end of this article.

## III. Vesting Generally

Under section 83, a "substantial risk of forfeiture" is found if a "person's rights to full enjoyment of [the] property are conditioned upon the performance of substantial services by the individual."<sup>10</sup> Regulations take the statutory requirement that rights be conditioned on the "performance of substantial services" and split the condition into two types: the performance (or nonperformance) of substantial services and "the occurrence of a

<sup>6</sup>Prop. Treas. reg. section 1.409A-3(g)(1).

<sup>7</sup>Section 409A(a)(2).

<sup>8</sup>Prop. Treas. reg. section 1.409A-3(g)(1). On its face, the proposed rule seems contrary to legislative history, which states that the occurrence of an event may not be treated as a "specified time" for purposes of the payout trigger rule. The example is a child beginning college. H. Rept. 108-755, 108th Cong. 1st Sess. 520 (Oct. 7, 2004). Yet the proposed rule strikes us as a logical way to handle one necessary outcome of the way the proposed regulation defines deferred compensation. Under the proposed regulation, any amount paid within 2½ months of the vesting year is not deferred compensation, so an arrangement can be always designed to avoid section 409A by specifying a section 409A vesting event as the payout date. Accordingly, any event is a good payout date if it is also a good section 409A vesting condition. It thus seems to us a short and rational step also to provide that the vesting event plus a stated period of time is also a good payout date.

<sup>9</sup>Prop. Treas. reg. section 1.409A-6(a)(2).

<sup>10</sup>Section 83(c)(1).

<sup>2</sup>Prop. Treas. reg. section 1.409A-1(b)(1).

<sup>3</sup>Prop. Treas. reg. section 1.409A-1(b)(4)(i). In addition, the short-term deferral rule does not apply if further deferrals are available.

<sup>4</sup>Prop. Treas. reg. section 1.409A-1(b)(4)(i).

<sup>5</sup>Section 409A(a)(1)(A)(i) and (ii).

condition related to a purpose of the transfer."<sup>11</sup> Regulations also require that the possibility of forfeiture be substantial if the condition is not satisfied.<sup>12</sup>

The statutory definition of vesting under section 409A is virtually identical to that under section 83. Section 409A(d)(4) provides that compensation is subject to a "substantial risk of forfeiture" if the "person's rights to such compensation are conditioned upon the future performance of substantial services by any individual." Like the regulation under section 83, the section 409A proposed regulation provides a two-pronged definition of "substantial risk of forfeiture." First, that risk may involve a contingency based on "the performance of substantial future services," and second, it may involve a condition "related to a purpose of the compensation."<sup>13</sup> As under the section 83 regulation, possibility of forfeiture must be substantial in both cases.<sup>14</sup>

A footnote in the conference committee report accompanying enactment of section 409A states that the concepts of "substantial risk of forfeiture" under section 409A are, for the most part, to be identical to those under section 83.<sup>15</sup> That instruction is unsurprising given the Supreme Court's directive that identical words in the code should be interpreted the same way.<sup>16</sup>

Section 409A also authorizes Treasury to issue regulations disregarding substantial risks of forfeiture in cases "where necessary to carry out the purposes of this section."<sup>17</sup> Based on legislative history, the forfeiture risks to be disregarded are those that are "illusory or used in a manner inconsistent with the purposes of the provision."<sup>18</sup> The example of an "illusory" vesting clause is one in which an executive effectively could "control" the acceleration of vesting. That admonition, however, does not suggest any major deviation from the time-honored interpretation of section 83, which had always cautioned that "risk of forfeiture clauses" must be examined to determine their effective enforceability against controlling shareholders.<sup>19</sup> One detail of the conference report example, however, is striking: It expresses concern about manipulation to accelerate vesting, rather than to defer it. By contrast, the IRS in recent years has shown more

enforcement concern about participants' ability to extend vesting periods, particularly in section 457, which uses the same definition of vesting as section 83. Indeed, the section 409A proposed regulation demonstrates the IRS's paramount concern with vesting extensions, as it allows acceleration of vesting at any time for section 409A purposes, but restricts the parties' ability to extend vesting.<sup>20</sup> From legislative history, however, it may be inferred that lawmakers' larger policy concern is the ability to control vesting in either direction — acceleration or extension.

#### IV. Vesting Under Section 83 — Details

To demonstrate how radical the new definition of vesting under section 409A is, we first undertake a long march through the principles of vesting under section 83 as developed by longstanding IRS guidance.

##### A. Substantial Services

Regulations under section 83 provide that the concept of "substantial services" embodies both the performance of services and the nonperformance of services, such as a noncompete agreement. For service performance conditions, the regulations focus on the regularity and duration of services.<sup>21</sup> How long must the service period be? The answer is not entirely clear.

A two-year service minimum is suggested by one example in the section 83 regulations.<sup>22</sup> That two-year example has been cited in numerous private letter rulings under section 457.<sup>23</sup> There are informal indications that the IRS views the two-year service period as a safe harbor rather than an absolute minimum. At least one ruling has held otherwise, however, and ruled that benefits in a section 457(f) plan vested immediately, reasoning that the plan's vesting service period was not a substantial risk of forfeiture because it was less than two years.<sup>24</sup>

A one-year service requirement will possibly, but not certainly, delay vesting under section 83. Regulations give an example of a stock grant that becomes nonforfeitable at a 10 percent rate for each year of service.<sup>25</sup> The regulation does not provide that the first 20 percent of the grant vests immediately because the first two years of service are insubstantial, but states instead that the graded vesting schedule is a good vesting condition even for the first two years. A private ruling reached the same conclusion for a section 457(f) plan with 10 percent graded vesting for each year of service.<sup>26</sup> One-year cliff vesting has been blessed for a custodial account under a section 403(b)(7) annuity, by a ruling concluding that the plan's service requirement of one year and one day is a "substantial risk of forfeiture."<sup>27</sup> The ruling should be

<sup>11</sup>Treas. reg. section 1.83-3(c)(1).

<sup>12</sup>*Id.*

<sup>13</sup>Prop. Treas. reg. section 1.409A-1(d)(1).

<sup>14</sup>*Id.*

<sup>15</sup>The legislative history of section 409A describes the general rule whereby a plan failing to satisfy section 409A will be taxed to the participant when there is no longer a "substantial risk of forfeiture." Footnote 808 of the conference committee report for H.R. 4520 states as follows: "As under section 83, the rights of a person to compensation are subject to a substantial risk of forfeiture if the person's rights to such compensation are conditioned upon the performance of substantial services by an individual" (emphasis supplied). H. Rept. 108-755, 108th Cong. 1st Sess. 519, n. 808 (Oct. 7, 2004).

<sup>16</sup>*Commissioner v. Keystone Consolidated Industries*, 508 U.S. 152, 159 (1993); *Sorenson v. Sec. of Treasury*, 475 U.S. 851, 860 (1986); *Atlantic Cleaners & Dyers, Inc. v. United States*, 286 U.S. 427, 433 (1932). See also discussion at n.1, *supra*.

<sup>17</sup>Section 409A(e)(5).

<sup>18</sup>H. Rept. 108-755, 108th Cong. 1st Sess. 525 (Oct. 7, 2004).

<sup>19</sup>Treas. reg. section 1.83-3(c)(3).

<sup>20</sup>*Supra* note 13. We discuss those restrictions in more detail below.

<sup>21</sup>Treas. reg. section 1.83-3(c)(2).

<sup>22</sup>Treas. reg. section 1.83-3(c)(4), Example (1).

<sup>23</sup>See, e.g., LTRs 9713014, 9723022, and 9211037.

<sup>24</sup>LTR 9211037.

<sup>25</sup>Treas. reg. section 1.83-3(c)(4), Example 3.

<sup>26</sup>LTR 9212011 (Dec. 19, 1991).

<sup>27</sup>LTR 8819043 (Feb. 12, 1988).

treated with some caution, however. Employees' participation in the plan was on a voluntary, salary-reduction basis, so vesting was apparently contingent on both a one-year period of service and a one-year period of voluntary salary reduction. Little or no authority clearly blesses a one-year vesting period absent some other vesting condition, like graded vesting or an additional vesting contingency.

That a one-year service period may be too short for section 83 vesting is also suggested in the Tax Court's opinion in *Robinson v. Commissioner*, 82 T.C. 444 (1984) *rev'd on other issues*, 805 F.2d 38 (1st Cir. 1986). Although the *Robinson* case dealt with a resale restriction on stock, and not a service requirement, the Tax Court held that the resale restriction was not a substantial risk of forfeiture because the one-year restriction was "relatively short" and hence an "insubstantial period of time."

A service requirement of less than one year is suspect under section 83. Where the line is crossed is unclear. One ruling holds that a 250-hour period of service is too short to delay vesting.<sup>28</sup> A field service advice concludes that 15 days of service is too short.<sup>29</sup> Two rulings appear to suggest that a two-month period is too short.<sup>30</sup>

Much guidance deals with the minimum length of services, but little with its quality or quantity. Two rulings make clear that actual work is expected: Accrued paid vacation failed to qualify as "substantial services" for section 83 vesting purposes, even if treated as paid employment for payroll purposes.<sup>31</sup>

**A service requirement of less than one year is suspect under section 83. Where the line is crossed is unclear.**

Whether postretirement consulting service is a good vesting condition is a matter of facts and circumstances. The issue seems to turn not on the length of the services, but on the likelihood that services will be required. One general counsel memorandum declined to recognize a postretirement service condition when the IRS could not find any real likelihood that the services would be performed, and further stated that the employer's past practice with respect to postretirement services must be considered to determine the parties' intent.<sup>32</sup>

An agreement to refrain from performing services, like a noncompete agreement, can defer vesting under section 83. A noncompete agreement will "not ordinarily" be treated as a substantial risk of forfeiture; that presump-

tion can be overcome by examining the age and skill of the worker and the likelihood that the individual will seek other employment.<sup>33</sup> Oddly, nothing in the regulations or other guidance mentions the length of the required noncompete period.

A service-based vesting period was allowed to be extended in a ruling in which the extended vesting period was negotiated bilaterally by the parties and the extended service period was "substantial."<sup>34</sup> Many practitioners have interpreted that ruling to stand for the proposition that service periods can be extended and still be good vesting conditions, even if the vesting extension is elected unilaterally by the employee. That "rolling risk of forfeiture" idea has become popular, although the IRS has expressed concern with it, especially for tax-exempt plans under section 457(f).<sup>35</sup>

**B. 'Conditions Related to the Purpose'**

The section 83 regulations provide several examples of good "conditions related to the purpose of the transfer" for vesting purposes. Two examples involve contingencies related solely to the employer's business: attainment of a specified level of corporate profitability and the successful completion of a stock underwriting.<sup>36</sup> A third example is different and allows a vesting contingency that is purely personal to the employee. The funded trust in that example pays a grant each year the employee's child completes a year of school. Amounts are held to vest under section 83 only as the child completes each semester, as that is the "condition related to the purpose of the transfer."<sup>37</sup> Nothing in the example indicates that the employee even has to be employed on the date each annual grant is paid.

Other contingent events have been blessed by the IRS as good vesting conditions under section 83, including a change in control, disability, death, dislocation, and plan termination.<sup>38</sup> Benefits conditioned on completion of an apprenticeship training program were treated as unvested until the training program was completed, although it is unclear how many classroom hours were required.<sup>39</sup> A trust funding an indemnification program for corporate directors and officers was treated as unvested until the individual incurred the covered liability.<sup>40</sup>

An employer's sole discretionary ability to delay or deny payment is sufficient to defer vesting. When a trustee had complete discretion to pay a particular

<sup>28</sup>LTR 8644004 (July 25, 1986).

<sup>29</sup>FSA Vaughn #5067 (Apr. 22, 1997).

<sup>30</sup>LTRs 7936007 (1979) and 7937084 (June 18, 1979). Those rulings are poor authority for any single conclusion, however, as they give additional reasons for concluding that there is no substantial risk of forfeiture, including a facts and circumstances analysis, plus the more salient fact that the two-month period of "services" was a period of accrued paid leave, rather than services.

<sup>31</sup>LTRs 7936007 and 7937084.

<sup>32</sup>GCM 37479 (Mar. 29, 1978).

<sup>33</sup>Treas. reg. section 1.83-3(c)(2).

<sup>34</sup>LTR 9431021, 94 TNT 154-36.

<sup>35</sup>See Brisendine, "Current Issues in Section 457 Deferred Compensation Plans," *Benefits Law Journal*, Winter 1996, p. 33; Needles and Butlack, "Deferred Compensation Planning for Executives of Tax Exempt Employers," *Taxation of Exempts*, November/December 2004.

<sup>36</sup>Treas. reg. section 1.83-3(c)(2).

<sup>37</sup>Treas. reg. section 1.83-3(c)(4), Example 2.

<sup>38</sup>LTRs 200007021, *Doc 2000-4951*, 2000 TNT 35-30 (disability, death, dislocation); 9429007, 94 TNT 143-26 (change of control); 9822030, *Doc 98-1660*, 98 TNT 104-35 (plan termination).

<sup>39</sup>LTR 8733012 (May 17, 1987).

<sup>40</sup>LTR 8822050 (Mar. 4, 1988).

funded benefit, the exercise of the discretion was determined to be a condition related to the purpose of the transfer, and benefits did not vest until the discretion was exercised.<sup>41</sup> Similarly, restricted stock that became nonforfeitable only on voluntary retirement with the employer's consent was treated as nonvested until the consent was given.<sup>42</sup> Express employer discretion to waive a vesting requirement and thus accelerate vesting does not invalidate an otherwise substantial vesting condition.<sup>43</sup> Similarly, the employer's discretionary failure to enforce a forfeiture provision, thus extending the vesting period, does not invalidate the forfeiture provision and does not trigger earlier vesting.<sup>44</sup>

Involuntary termination of employment generally appears to be a good section 83 vesting condition. Benefits that become payable solely if the employee is terminated because of layoff, disability, and similar events will be treated as unvested until the employee is let go, according to at least four rulings.<sup>45</sup> One ruling, however, reached a contrary result and concluded that benefits vested immediately under section 83, in a plan in which awards became nonforfeitable on involuntary termination.<sup>46</sup>

Voluntary termination of employment is apparently not a good section 83 vesting condition. For example, if an employee must both meet a service condition and terminate employment to get payout of a benefit, the termination requirement does not further delay vesting once the service requirement is met.<sup>47</sup> Voluntary termination can be a good vesting condition, however, if coupled with a second contingency. For example, when grants of restricted stock became nonforfeitable if the employee terminated after one year of service with the employer's consent, the grants were determined to be nonvested until employer consent was given, when the employer's past practice showed that out of the past seven such voluntary terminations, the employer had consented to only two.<sup>48</sup> Similarly, a GCM concluded that an employee's voluntary retirement was a good vesting condition, in a plan in which restricted stock awards became nonforfeitable at retirement but only if, at the time of retirement, the employee also held stock in a matching escrow account.<sup>49</sup>

While voluntary termination by itself does not appear to be a good vesting condition, guidance shows some confusion on that point. At least one ruling appears to bless a "retirement-based" vesting condition.<sup>50</sup> That part of the holding, however, is confined to contracts entered

into after the plan's vesting and retirement age of 60, while contracts entered into earlier appear to have a two-year service vesting period. One GCM has expressly stated that voluntary retirement is a good section 83 vesting condition and awards subject to that condition are therefore not vested before retirement.<sup>51</sup> Analogizing to *Knapp v. Commissioner*, 41 B.T.A. 23 (1940), the GCM reasons that by retiring, the employee forgoes a valuable right and the retirement condition for receiving the benefit is thus a real restriction.

If it could be trusted, the GCM's analysis would seem right to us. As we discuss below, the IRS has blessed many other vesting conditions solely within the employee's control, like a former employee's observance of a noncompete agreement. Those are all substantial restrictions because, by agreeing to them, the individual gives up a valuable right. The same should logically hold true of benefits payable only if the employee decides to give up his job. But we suspect that the GCM does not reflect the IRS's thinking, then or now, and indeed its reasoning goes beyond its facts. Under the facts of the GCM, the employee vested in an award on retirement only if, at the time of retirement, he also held employer stock in escrow. Its *Knapp* analysis is thus merely dictum, and the ruling is probably better viewed as an example of voluntary termination as a good vesting condition when coupled with a second condition.

A benefit conditioned solely on a participant's death is not vested under section 83 until death occurs, but a benefit that is otherwise payable, and forfeited only if the participant dies before payment, is treated as a vested benefit.<sup>52</sup>

A contingency can be a good section 83 vesting condition even if it is solely within the employee's control. When grants of restricted stock that were still forfeitable at an employee's retirement, but became nonforfeitable after retirement on the condition that the retiree hold matching stock in escrow for some period of years, the postretirement escrow requirement was held to be a good section 83 vesting condition, even though the retiree could withdraw the stock at any time.<sup>53</sup> Likewise, a benefit contingent on the signing of a partnership agreement was held to be nonvested until the agreement was signed.<sup>54</sup> A section 457(f) benefit apparently contingent on the employee's voluntary salary reduction was treated as nonvested until the minimum salary reduction period had elapsed.<sup>55</sup> Finally, under regulations, a valid noncompete agreement is not ignored just because the individual can freely take other employment.

The IRS has generally concluded that whether a risk of forfeiture is substantial turns on whether the forfeiture

<sup>41</sup>LTR 8409067 (Nov. 30, 1983).

<sup>42</sup>LTR 8326151 (Mar. 31, 1983).

<sup>43</sup>*Alves v. Commissioner*, 79 T.C. 864 (1982); LTR 8322079 (Mar. 3, 1983); LTR 9431021.

<sup>44</sup>LTR 7829007 (Apr. 14, 1978).

<sup>45</sup>LTRs 199916037, Doc 1999-14807, 1999 TNT 79-38; 200321002, Doc 2003-12732, 2003 TNT 101-21; 9317010, 93 TNT 95-40; 20007021.

<sup>46</sup>LTR 9031031 (May 8, 1990).

<sup>47</sup>TAM 199903032, Doc 1999-3332, 1999 TNT 15-25.

<sup>48</sup>*Supra* note 42.

<sup>49</sup>GCM 38739 (June 1, 1981).

<sup>50</sup>LTR 9030028 (Apr. 27, 1990).

<sup>51</sup>*Supra* note 49.

<sup>52</sup>LTRs 8342002 (June 24, 1983) and 9810005, Doc 98-8395, 98 TNT 45-13; see also Treas. reg. section 31.3121(v)(2)-1(e)(4)(B) (benefit is reasonably ascertainable under section 3121(v) if only variables are interest and mortality).

<sup>53</sup>*Supra* note 49.

<sup>54</sup>*Hensel Phelps Construction Co. v. Commissioner*, 74 T.C. 939 (1980).

<sup>55</sup>LTR 8819043 (Feb. 12, 1988).

condition is likely to occur.<sup>56</sup> The case law does not necessarily support that position. In *Robinson v. Commissioner*, the First Circuit stated that whether pay is subject to a substantial risk of forfeiture turns not on whether the forfeiture condition is likely to occur, but on whether forfeiture is likely to occur once the triggering event happens.<sup>57</sup>

What type of contingency is a good section 83 vesting condition? In *Robinson v. Commissioner*, the First Circuit held that a good vesting condition must serve "an important business purpose" other than mere delay of taxation, further stating that the vague goal of "continued performance and loyalty" meets that test.<sup>58</sup> In GCM 38739, the IRS similarly stated that a good section 83 vesting condition must further an objective of the transferor other than "mere deferral of the recipient's taxes." The GCM concludes that a nonforfeiture condition requiring that an employee hold stock in escrow even after retirement meets that test because stock ownership, and even the prospect of continued stock ownership after retirement, "fosters both long-term decision making and loyalty to the Company." Based on those authorities, virtually any nonfrivolous condition would be a good section 83 vesting condition.

### C. Summary: Vesting Under Section 83

While the authorities are not entirely consistent on all points, here is what can be said about vesting under section 83: Vesting can be deferred by requiring that the employee perform "substantial services," or that there occur a "condition relating to the purpose of the transfer." Substantial services can safely be said to include services regularly performed over a period of at least two years, although vesting over a shorter period is safe as part of a "graded" vesting schedule. A service period as short as one year is possibly but not certainly safe, a service period of less than one year is suspect, and a service period of 250 hours is insufficient. A requirement for services after termination of employment might be a good vesting condition — even if for less than two years — but the IRS will heavily scrutinize the employer's past practice to see if the vesting condition is real. Similar considerations apply for postemployment noncompete agreements.

A "condition related to the purpose of the transfer" can be virtually any contingency, whether or not related to the employer's business purposes. Thus, benefits will not vest if conditioned on an employee's child completing a semester of college, the occurrence of an event covered by an indemnification agreement, a takeover, termination of the plan, involuntary termination of employment, the employee's willingness to hold stock in escrow, or even the employer's exercise of discretion whether to pay the benefit. The fact that the contingency

<sup>56</sup>See, e.g., GCM 38739 (stock escrow requirement a good vesting condition, in part because likelihood stock escrow would be abandoned was "not remote").

<sup>57</sup>805 F.2d 38 (1st Cir. 1986).

<sup>58</sup>*Id.*

is in the sole control of either the employer or the employee does not disqualify it as a good vesting condition under section 83.

## V. Vesting Under Section 409A — Details

### A. Substantial Services

As under section 83, compensation under section 409A is subject to a substantial risk of forfeiture if it is conditioned on the performance of substantial future services and the possibility of forfeiture is substantial. While similar to the approach under section 83, the section 409A guidance suggests significant differences.

Unlike the section 83 regulations, section 409A guidance does not specifically touch on duration of the services. Many of the examples in the section 409A proposed regulation, however, are phrased in terms of two years of service, so it seems clear the regulation writers were attuned to the two-year authorities under section 83.<sup>59</sup> As under the section 83 authorities, there is also some indication that a one-year service period is enough. The support for that position is found in a special rule provided by proposed regulations for some initial deferral elections. The special rule provides that an initial deferral election may be made within 30 days of the establishment of a legally binding right — rather than in the year before the year the services are performed as otherwise required by statute — if the required service period is at least 12 months.<sup>60</sup> Here, the regulation writers apparently think that a 12-month service requirement is sufficiently substantial to make a promise nonvested.<sup>61</sup> On the other hand, the 12-month service period in the special rule is absolute: Amounts must be forfeited if services cease for any reason, including the death or disability of the service provider. By contrast, for section 83 purposes, a two-year service period defers vesting even if amounts vest on death or disability. For section 409A purposes, we are accordingly left with the same murky conclusion as for section 83 purposes: To defer vesting, substantial services for two years is definitely enough, for one year, probably but not certainly.

What about the required regularity of the services for the two- or one-year period? On its face, the section 409A proposed regulation does not address that issue. But a question arises whether the answer is found in the proposed rule that attempts to identify the "termination of employment" date for permitted payout purposes. Because "termination of employment" is a payout trigger under section 409A, the proposed regulation defines that term to prevent delays in payouts that would otherwise be required by employment termination, but the parties attempt to defer payout by arranging for nominal continuation of employment in which ongoing services are

<sup>59</sup>Prop. Treas. reg. section 1.409A-1(b)(6)(ii) (two years of employment); prop. Treas. reg. section 1.409A-3(g) (three years of employment).

<sup>60</sup>Prop. Treas. reg. section 1.409A-2(a)(4).

<sup>61</sup>Note that that special rule under the proposed regulation (allowing a 30-day election window for pay conditioned on a 12-month service period) is distinct from the statutory rule allowing a 30-day election window for new plan entrants.

minimal.<sup>62</sup> That antidelayer rule deems the employment relationship to be "insignificant," and termination of employment to occur, if the employment services drop below 20 percent of the prior three-year average. Does that test also apply if vesting is based on services? For example, what happens if halfway through a three-year vesting period, the employee drops back to a part-time schedule at a rate of 15 percent of the prior work? If the employment is "insignificant" for purposes of the payout trigger, is it also "insubstantial" for purposes of an employment-based vesting condition? Further guidance might be helpful on that issue.

Guidance under section 409A also differs from the section 83 regulations in a number of important respects. First, the section 409A proposed regulation does not treat the nonperformance of duties as a vesting condition.<sup>63</sup> Accordingly, a noncompete agreement does not delay vesting under section 409A. Second, it is unclear whether section 409A guidance ever allows the parties to extend the vesting period by extending the period of required services.<sup>64</sup> The proposed regulation is not clear on that point: In one sentence it states that under no circumstances can the vesting period be lengthened, but later in the same paragraph suggests an exception and seems to permit vesting if the extension is bargained for and granted in return for a "material" increase in the consideration, such as additional compensation.

The section 409A guidance raises another question. The proposed regulation states that vesting services are limited to those rendered to a "service recipient," which has a controlled group definition.<sup>65</sup> It is thus unclear what happens if a deferred compensation plan takes into account services with a less-than-80-percent subsidiary. The same question arises for a deferred compensation promise made by an employee leasing company when all services by the leased employees are rendered to other entities.

#### B. 'Condition Related to the Purpose'

The section 409A proposed regulation spells out a narrow category of conditions treated as "related to a purpose of the compensation." The proposed regulation states that the condition must "relate to the service recipient's business activities or organizational goals."<sup>66</sup> Examples include conditions based on earnings, stock values, or an initial public offering. The preamble also provides that involuntary termination is a condition related to the purpose of the transfer and is a good section 409A vesting condition.<sup>67</sup>

Because the section 409A test is crafted so narrowly, many conditions that are good vesting conditions under section 83 are not under section 409A. That includes all contingent events not related to the business purpose or organizational goals of the service recipient. As the clearest example of the difference, consider that the

section 83 regulations state that a purely personal contingency — the child's completion of college — is a good vesting condition for amounts payable from a funded educational trust.<sup>68</sup> By contrast, that contingency does not defer vesting under section 409A. An unfunded promise to pay tuition costs would thus typically vest at some earlier time, meaning that payments would typically fall outside the 2½ month window and be deferred compensation subject to the fixed payout date and other requirements of section 409A.

#### VI. Different Approaches Cause Problems

The inconsistent treatment of vesting conditions under sections 83 and 409A raises a number of vexing problems. The most significant of those is the inconsistent results reached when the rules are applied to event-triggered benefits such as reimbursements and indemnities. Affected benefits include expense reimbursements, tax gross-ups, indemnity agreements for legal fees and other liabilities, and golden parachutes. The inconsistent interpretations also have ramifications for the section 409A grandfather.

For example, consider an unfunded promise to pay relocation costs for an incoming senior executive, including such hard-to-predict items as a make-whole payment for any capital loss on the sale of his residence, plus a full tax gross-up. Assume that the promise is made by a calendar-year taxpayer on December 31, 2005, for relocation items incurred by the end of 2006. Occurrence of a reimbursed or indemnified event is not a good vesting event, so for purposes of the 2½-month rule the promise vests on December 31, 2005, when the legally binding right arises. Most or all reimbursements will fall outside of the 2½-month rule, and will be deferred compensation under section 409A. Yet section 409A apparently cannot be satisfied. To qualify under section 409A, a plan must describe the timing and amount of the payments.<sup>69</sup> The timing requirement can be solved, with considerable inconvenience to the executive, by specifying a safe outside payment date, like July 1, 2007. It is not clear that the "amounts" requirement can be satisfied, however, as the costs are as yet unknown. The exact dollar amount of the payment does not have to be spelled out, as long as there is an "objective formula" by which the amount can be calculated.<sup>70</sup> But it is unclear that "the amount of capital loss on a principal residence" is an objective formula for that purpose.

Similar problems arise with all sorts of reimbursement promises: promises to pay personal travel on company aircraft, country club dues, financial planning expenses, tax gross-ups, and educational expenses. All may well fail section 409A because, even if the timing requirement could be fixed, the amounts requirement likely cannot be. Some have suggested that this section 409A problem may be solved by adding an express employment condition to defer the vesting date. If the employee must be actively employed on the date the contingent event arises — the

<sup>62</sup>Prop. Treas. reg. section 1.409A-1(h)(1).

<sup>63</sup>Prop. Treas. reg. section 1.409A-1(d).

<sup>64</sup>Prop. Treas. reg. section 1.409A-1(d)(1).

<sup>65</sup>Prop. Treas. reg. section 1.409A-1(d)(1), -1(g).

<sup>66</sup>Prop. Treas. reg. section 1.409A-1(d)(1).

<sup>67</sup>70 Fed. Reg. 57930, 57941 (Oct. 4, 2005).

<sup>68</sup>Treas. reg. section 1.83-3(c)(4), Example 2.

<sup>69</sup>Prop. Treas. reg. section 1.409A-1(c)(3).

<sup>70</sup>*Id.*

relocation events are completed, the child completes a semester of school, the country club dues are paid, and so forth — it has been suggested that the benefit does not vest until the day on which that service condition is met. By deferring the vesting date, it will generally be easier to escape section 409A by squeezing all payments into the 2½ month rule.

Unfortunately, adding an employment condition will not always change the analysis. If section 409A follows the guidance laid down under section 83, services must endure for perhaps as long as two years, and almost certainly for at least one year, to qualify as a good vesting condition. Accordingly, it may be necessary to peg vesting to an entire year or two of services to get a cognizable vesting date. The problem with paying the relocation costs of the incoming executive in our example is apparent, as his two-year service date will not arise until well after his relocation costs are incurred.

Reimbursements become even more problematic if promised as part of a severance or retirement package to a terminated employee, for whom a service condition is no longer possible. Consider, for example, the typical golden parachute agreement. In addition to the severance payment, the company generally makes two contingent promises: to pay a tax gross-up to cover any section 4999 excise tax and to indemnify any future legal costs arising from IRS challenges.

It is virtually certain that the tax gross-up and indemnity promises must be deferred compensation under section 409A, as they must almost certainly pay later than two-and-a-half months after the vesting year. To see why that is so, consider what could be the latest possible vesting event: It's not termination of employment, because termination is an acceptable vesting event under section 409A only if it is involuntary, and parachutes typically cover both voluntary and involuntary terminations. The latest vesting event is thus probably the change in control, as a trigger related to the employer's organizational goals or business activities. No matter how soon the employee terminates following the change-in-control vesting event, payments will almost certainly fall outside the 2½-month window and will be deferred compensation. That is because, typically, calculating the golden parachute excise tax and gross-up payment takes a considerable amount of time, with computations undertaken by an agreed-on third party like a national accounting firm. Those computations can, in our experience, take many months. Specifying the timing of payout will be difficult or impossible.

Even if the timing problem could be fixed — say, by specifying an outside time such as three years after the employment termination — it would be difficult or impossible to specify the amount. Arguably, the arrangement solves the "amount" requirement because calculating the tax gross-up involves an objective formula (section 4999 tax rate times excess parachute payment times gross-up fraction). On the other hand, guidance remains unclear whether even that is sufficient to satisfy section 409A.

The same problems beset the tax indemnification promise, but even more so, because we cannot know either the timing or the amount of the payment. The timing is uncertain because it depends on whether the

IRS challenges the original parachute excise tax calculations. The amount is uncertain because the indemnification covers the cost of the defense, which is not calculable until the costs are incurred.

Can it be argued that the section 409A vesting events for the tax gross-up and indemnification promise take place later, thus placing the amounts within the 2½-month rule and outside section 409A? Probably not. For example, one logical position would be to argue that the third party's computation of the excise tax is the section 409A vesting event for payment of the severance and tax gross-up, and resolution of any IRS challenge is the section 409A vesting event for the indemnification provisions. Unfortunately, that approach does not seem to be a solution. Under the proposed regulations, computation of the tax gross-up, or the occurrence of an IRS challenge, is not a good vesting event because it is neither service-related nor related to the company's business.

Another possible solution to the problem of contingent promises would be to take the position that they are not deferred compensation, despite failing the 2½-month rule because they fall under the rule permitting delay when it is "administratively impractical" to make payment within the 2½-month window.<sup>71</sup> That approach is also problematic. The "administratively impractical" exception is available only for payments for which the inability to compute was not foreseeable when the promise was made — a condition arguably not present in this case. Accordingly, the indemnification provisions of the typical parachute agreement necessarily fail section 409A.

## VII. Section 83 to the Rescue?

One way to salvage the indemnification payment in the last example would be to add some other vesting requirement to the mix. For example, the employer could borrow from section 83 guidance and condition the audit indemnification promise on the employee's owning shares of stock in the successor entity at the time the audit expenses are incurred. Would that stock-owning requirement be enough to establish a vesting condition under section 409A as it did under section 83? The answer is not clear because it is unclear which of section 83's vesting conditions the IRS has abandoned under section 409A and which it has retained.

Given the uncertainty of the law under section 409A, a completely different approach would be to fund the promise, to place it under sections 83 and 402(b). Once under section 83, the promise is out of section 409A.<sup>72</sup> Possible funding mechanisms include a letter of credit or a trust. Having thus funded the benefit, the employer can then delay vesting and taxation of the funded benefit by any of the means permitted under section 83 guidance. Consider, for example, a promise funded by a letter of credit to pay golden parachute severance benefits, tax gross-up on the parachute excise tax, and indemnification against IRS challenge. Most simply, the parties can take the position that the event is not vested for section 83

<sup>71</sup>Prop. Treas. reg. section 1.409A-1(b)(4)(ii).

<sup>72</sup>Prop. Treas. reg. section 1.409A-1(b)(6).



purposes, and thus not taxable, until the contingency arises. In addition, the employer could require that the employee maintain an employer stock account as a condition of receiving the promised parachute payments. That would not only add an extra section 83 vesting condition, it would delay vesting and taxation until the date of the reimbursement, rather than the date of the contingent event.

Funding the benefit raises issues of its own. The first is how much of the benefit must be funded to come under sections 83 and 402(b) and not under section 409A. The answer is not clear. If, for example, \$10 were placed in trust to fund a contingent liability with a present value of \$1 million, it seems unlikely the IRS would agree that the entire benefit fell outside of section 409A. The more likely answer would be that the benefit is a section 83 or 402(b) benefit only to the extent funded, and a section 409A benefit otherwise. Does the answer change if the employer also has a binding obligation to fund the benefit on the occurrence of the stated contingency? Again, the answer is not clear.

The second issue is whether the promise falls under ERISA, and if so, the consequences of funding it. If ERISA applies, funding the promise means that it no longer falls under the "top-hat" plan exception for unfunded plans.<sup>73</sup> That problem has especially unpleasant consequences for benefits that extend beyond termination of employment, as those could be ERISA pension plans, rather than the more lightly regulated welfare benefit plan. The pension plan problem and its potentially broad reach was shown in the *Schwegmann* case, in which the Fifth Circuit ruled that a supermarket's promise to furnish postretirement employee discounts was an ERISA pension plan.<sup>74</sup> If the postretirement benefit is an ERISA pension plan, then by forfeiting its top-hat status, the employer will have subjected it to ERISA's especially complex requirements for those plans, including ERISA's requirements for accrual, vesting, and funding of the "accrued benefit."

While they must be dealt with, the ERISA issues are soluble. For many promises, the simplest approach will be to take the position that they are not ERISA plans under the *Fort Halifax* line of cases because they lack sufficient "administrative apparatus."<sup>75</sup> That might be argued, for example, in the case of the bundle of promises in a golden parachute agreement, including severance pay, excise tax gross-up, and indemnity. A second possible approach for many promises is to take the position that, even if they are ERISA plans, they are welfare benefit plans, rather than the more onerous pension plans. A promise to indemnify legal fees, for example, is

a plan for "prepaid legal services," which is an ERISA welfare benefit plan.<sup>76</sup> A third approach, for promises that appear to be more clearly like pension benefits, is to structure them as account balance plans, probably with suspense accounts that remain unallocated until the contingency occurs or the amount is paid. That avoids the accrual rules applicable to defined benefit plans, and ensures that any vesting applies only to a zero allocated benefit until the need for reimbursement arises.

### VIII. Vesting and the Section 409A Grandfather

An interesting sidebar to the discussion of vesting under section 409A is the interpretation of the grandfather rule. Under section 409, a deferred compensation benefit is grandfathered only if it was vested before 2005. For that purpose, however, guidance pulls a bait-and-switch on the vesting definition. The proposed regulation states that vesting for grandfather purposes is determined on the basis of vesting not under section 409A, but rather under section 83.<sup>77</sup> As we have discussed, vesting under section 83 will often occur later than vesting under section 409A because section 83 recognizes more conditions as good vesting conditions. As a result, for grandfather purposes, fewer benefits were vested as of December 31, 2004, and more arrangements are consequently subject to section 409A.

**For grandfather purposes, guidance pulls a bait-and-switch on the vesting definition.**

Consider, for example, an employer's promise made in 2002 to indemnify IRS audit expenses in the golden parachute example discussed previously. Under guidance, the commencement of the IRS audit qualifies as a section 83 vesting condition for the indemnity promise.<sup>78</sup> That means that, if no audit had commenced as of December 31, 2004, that part of the golden parachute is not vested and not grandfathered. Moreover, the indemnification promise might be unvested and ungrandfathered even if the rest of the parachute agreement — the severance payments plus the excise tax gross-up — was vested because a change of control had occurred as of December 31, 2004. The upshot is that pre-2005 agreements will have to be dissected in fine detail to determine what is, and what is not, grandfathered under section 409A.

### IX. Conclusion

The IRS has proposed a narrow definition of the "substantial risk of forfeiture" in section 409A. As a theoretical matter, the first paradoxical result is that future promises to pay compensation are considered

<sup>73</sup>ERISA section 401(a)(1). If a plan is unfunded for tax purposes, the Labor Department has said that it will consider the plan to be unfunded for determining its ERISA top-hat status. ERISA Op. 89-22A (1989).

<sup>74</sup>*Musmeci v. Schwegmann Giant Super Markets, Inc.*, 332 F.3d 339 (5th Cir. 2003).

<sup>75</sup>*Fort Halifax Packing Co. v. Coyne*, 482 U.S. 1 (1987) (benefits that involve a one-time payment to former employees do not constitute an ERISA plan). See also *Kulinski v. Medtronic Bio-Medicus, Inc.*, 21 F.3d 254 (8th Cir. 1994); *Angst v. Mack Trucks, Inc.*, 969 F.2d 1530 (3d Cir. 1992).

<sup>76</sup>ERISA section 3(1)(A).

<sup>77</sup>Prop. Treas. reg. section 1.409A-6(a)(2).

<sup>78</sup>LTR 8822050 (Mar. 4, 1988) (funded indemnification of corporate directors and officers, not vested under section 83 until instigation of legal proceedings).

vested before the contingency arises, and in many cases as soon as the promise is made. Contingent promises are thus taxable as of their vest date — that is, taxable before it is known whether they will ever be paid. How the IRS will handle taxation on vesting is still under consideration. One possible approach would be to adopt the section 3121(v) model and tax the present value, discounted for probability of the contingency arising — at best raising difficult problems of valuation.<sup>79</sup> A second possible approach would wait until the contingency arises and tax on payout, but with interest back to the vest date, reflecting the policy judgment that the resulting tax is “late,” even though hitherto unknowable. A third possible approach would tax on the vest date with no discount for probability of occurrence, resulting in a radical break from existing principles of income receipt and economic benefit.

The second paradoxical result is that the promise is taxable under section 409A before the date it would be taxable under section 83 — meaning that the unfunded promise is taxed *before* the funded one, standing decades of tax policy on its head. The most perverse example of that counterintuitive result is in the grandfather rule. Many promises made before 2005 are not grandfathered because they are not yet vested under section 83 — yet they are subject to section 409A and possibly already in violation of its terms, because they’re vested under section 409A.

The third paradoxical result is that under section 409A, the cash-basis taxpayer is taxable before the accrual-basis taxpayer. That is because section 409A applies only to cash-method taxpayers.<sup>80</sup> Yet as a result of section 409A’s vesting concept, the contingent promise may be taxable when still only contingent, which could be well before the events arise that fix the liability and the amount of pay.

We question those results as a matter of theory and policy. There is no precedent for taxing deferred compensation not only while it is still unfunded, but while it is still forfeitable, unpayable, uncollectible, and unknowable. Moreover, we question that in going after Enron abuses, that is what Congress had in mind.

As a practical matter, the principal casualty of this new taxing structure is employers’ ability to make contingent promises to their employees and especially to their terminated and retired employees. As a result, all sorts of reimbursement agreements, tax gross-ups, and indemnification promises will be virtually impossible to offer under section 409A. In addition, it is to be expected that many arrangements will inadvertently cross the section 409A line and give rise to unwelcome section 409A results. As discussed above, the first result will be taxation of the promise under some regime to be determined. Moreover, under section 409A’s sweeping plan aggrega-

tion rule, the unlucky employee who holds a defective contingent promise subject to section 409A will see other arrangements of the same type — such as his supplemental executive retirement plan, or SERP — subject to immediate tax and penalties.<sup>81</sup> In addition, should the contingency arise, any amount paid is subject to tax, interest, and penalties back to the section 409A vesting date. Accordingly, while section 409A’s vesting structure may be merely baffling as a theoretical matter, its results can be catastrophic as a practical one.

***While section 409A’s vesting structure may be merely baffling as a theoretical matter, its results can be catastrophic as a practical one.***

We have touched on a number of possible solutions to the problems raised by section 409A’s vesting concept. One category of solutions works within the framework of section 409A and tries to make the promise fit its rules. One example of that approach is to ensure that the section 409A vesting event occurs as late as possible, so as to squeeze as many payments as possible into the 2½ month rule and out of the definition of deferred compensation. Another example is to start with the recognition that the payment will be deferred compensation and conform the payment to section 409A’s requirements by specifying its time and amount. For many kinds of payments, however, those solutions are partial and unsatisfactory.

A second category of solutions is to get the benefit out of section 409A by funding it. In that way, employers can make use of the more rational vesting concepts developed in the regulations and guidance under section 83. That approach takes the counterintuitive idea that the funded promise vests and taxes later than the unfunded one, and exploits it.

In conclusion, we believe that the IRS should reconsider its definition of vesting under section 409A. There is no policy reason to introduce a radical vesting concept that is contrary to settled tax principles and in practice may be easily avoided by employers willing to fund their deferred compensation promises.

<sup>81</sup>Prop. Treas. reg. section 1.409A-1(c) has an aggregation rule that defines as a single “plan” all arrangements of the same type covering the same service provider. For that purpose, plans are categorized into four types: account balance (defined contribution), nonaccount balance (defined benefit), equity based, and severance pay for involuntary termination. Depending on whether a reimbursement benefit is couched as an account balance or a nonaccount balance plan, its failure under section 409A will trigger tax and penalties for all plans of the same type covering the same employee — even if the reimbursement benefit is never paid because the contingency never arose to trigger the reimbursement.

<sup>79</sup>Treas. reg. section 1.3121(v)(2)-1(c)(2)(ii).

<sup>80</sup>Prop. Treas. reg. section 1.409A-1(f)(2).