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## **Reg. Section 1.409A-1(b)(6)**

### Definitions and covered plans

(a) Nonqualified deferred compensation plan.

(1) In general. Except as otherwise provided in this paragraph (a), the term nonqualified deferred compensation plan means any plan (within the meaning of paragraph (c) of this section) that provides for the deferral of compensation (within the meaning of paragraph (b) of this section). Whether a plan provides for the deferral of compensation generally is determined at the time the service provider obtains a legally binding right to the compensation under the plan, and is not affected by any retroactive change to the plan to characterize the right as one that does not provide for the deferral of compensation. For example, amounts deferred under a nonqualified deferred compensation plan do not become an excluded death benefit if the plan is amended so that the amounts are payable only upon the death of the service provider. If a principal purpose of a plan is to achieve a result with respect to a deferral of compensation that is inconsistent with the purposes of section 409A, the Commissioner may treat the plan as a nonqualified deferred compensation plan for purposes of section 409A and the regulations thereunder.

(2) Qualified employer plans. The term nonqualified deferred compensation plan does not include a qualified employer plan. The term qualified employer plan means any of the following plans:

(i) Any plan described in section 401(a) and a trust exempt from tax under section 501(a) or that is described in section 402(d).

(ii) Any annuity plan described in section 403(a).

(iii) Any annuity contract described in section 403(b).

(iv) Any simplified employee pension (within the meaning of section 408(k)).

(v) Any simple retirement account (within the meaning of section 408(p)).

(vi) Any plan under which an active participant makes deductible contributions to a trust described in section 501(c)(18).

(vii) Any eligible deferred compensation plan (within the meaning of section 457(b)).

(viii) Any plan described in section 415(m).

(ix) Any plan described in §1022(i)(2) of the Employee Retirement Income Security Act of 1974, Public Law 93-406 (88 Stat. 829, 942) (Sept. 2, 1974) (ERISA).

(3) Certain foreign plans.

(i) With respect to an individual for a taxable year, the term nonqualified deferred compensation plan does not include any scheme, trust, arrangement, or plan maintained with respect to such individual, to the extent contributions made by or on behalf of such individual to such scheme, trust, arrangement, or plan, or credited allocations, accrued benefits, earnings, or other amounts constituting income, of such individual under such scheme, trust, arrangement, or plan, are excludable by such individual for Federal income tax purposes pursuant to any bilateral income tax convention, or other bilateral or multilateral agreement, to which the United States is a party.

(ii) Participation by nonresident aliens, certain resident aliens, and bona fide residents of possessions. With respect to an alien individual for a taxable year during which such individual is a nonresident alien, a resident alien classified as a resident alien solely under section 7701(b)(1)(A)(ii) (and not section 7701(b)(1)(A)(i)), or a bona fide resident of a possession (within the meaning of section 937(a)), the term nonqualified deferred compensation plan does not include any broad-based foreign retirement plan (within the meaning of paragraph (a)(3)(v) of this section).

(iii) Participation by U.S. citizens and lawful permanent residents. With respect to an individual for a given taxable year during which such individual is a U.S. citizen or a resident alien classified as a resident alien under section 7701(b)(1)(A)(i), other than an individual who is also a bona fide resident of a possession (within the meaning of section 937(a)), the term nonqualified deferred compensation plan does not include a broad-based foreign retirement plan (within the meaning of paragraph (a)(3)(v) of this section), but only with respect to a plan, or a portion of a plan where such portion may be distinguished, providing for nonelective deferrals of modified foreign earned income, and earnings with respect to such nonelective deferrals, and only to the extent that the amounts deferred under all such plans of the service recipient, or all portions of such plans, in which the service provider participates in such taxable year, do not exceed the applicable limits under section 415(b) (applied to nonaccount balance plans as defined in paragraph (c)(2)(i)(C) of this section) and section 415(c) (applied to account balance plans as defined in paragraph (c)(2)(i)(A) of this section) that would be applicable if such plans were plans subject to section 415 and the modified foreign earned income of such individual were treated as compensation for purposes of applying section 415(b) and (c). For purposes of this paragraph (a)(3)(iii), the term modified foreign earned income means foreign earned income as defined in section 911(b)(1) without regard to section 911(b)(1)(B)(iv) and without regard to the requirement that the income be attributable to services performed during the period described in section 911(d)(1)(A) or (B). The provisions of this paragraph (a)(3)(iii) do not apply to any individual with respect to any taxable year in which the individual is simultaneously eligible to participate in a broad-based foreign retirement plan and a qualified employer plan

described in paragraph (a)(2) of this section. For purposes of this paragraph (a)(3)(iii), an individual is eligible to participate in a qualified employer plan if under the terms of the plan and without further amendment or action by the plan sponsor, the individual is eligible to make or receive contributions or accrue benefits under the plan (regardless of whether the individual has elected to participate in the plan).

(iv) Plans subject to a totalization agreement and similar plans. The term nonqualified deferred compensation plan does not include any social security system of a jurisdiction to the extent that benefits provided under or contributions made to the system are subject to an agreement entered into pursuant to section 233 of the Social Security Act (42 U.S.C. 433) with any foreign jurisdiction. In addition, the term nonqualified deferred compensation plan does not include a social security system of a foreign jurisdiction to the extent that benefits are provided under or contributions are made to a government-mandated plan as part of that foreign jurisdiction's social security system.

(v) Broad-based foreign retirement plan. The term broad-based foreign retirement plan means a scheme, trust, arrangement, or plan (regardless of whether sponsored by a U.S. person) that is written and that, in the case of an employer-maintained plan, satisfies the following conditions:

(A) The plan is nondiscriminatory insofar as the employees who, under the terms of the plan (alone or in combination with other comparable plans) and without further amendment or action by the employer, are eligible to make or receive contributions or accrue benefits under the plan other than earnings (regardless of whether the employee has elected to participate in the plan), are a wide range of employees, substantially all of whom are nonresident aliens, resident aliens classified as resident aliens solely under section 7701(b)(1)(A)(ii) (and not section 7701(b)(1)(A)(i)), or bona fide residents of a possession (within the meaning of section 937(a)), including rank and file employees.

(B) The plan (alone or in combination with other comparable plans) actually provides significant benefits for a substantial majority of such covered employees.

(C) The benefits actually provided under the plan to such covered employees are nondiscriminatory.

(D) The plan contains provisions or is the subject of tax law provisions or other legal restrictions that generally discourage employees from using plan benefits for purposes other than retirement or restrict access to plan benefits before separation from service, including (but not limited to), restricting in-service distributions except in events similar to an unforeseeable emergency (as defined in §1.409A-3(i)(3)(i)) or hardship (as defined for purposes of section 401(k)(2)(B)(i)(IV)), or for educational purposes or the purchase of a primary residence.

(4)Section 457 plans. A nonqualified deferred compensation plan under section 457(f) may constitute a nonqualified deferred compensation plan for purposes of this paragraph (a). The rules of section 409A apply to nonqualified deferred compensation plans separately and in addition to any requirements applicable to such plans under section 457(f). In addition, nonelective deferred compensation of non-employees described in section 457(e)(12) and a grandfathered plan or arrangement described in §1.457-2(k)(4) may constitute a nonqualified deferred compensation plan for purposes of this paragraph (a). The term nonqualified deferred compensation plan does not include a length of service award to a bona fide volunteer under section 457(e)(11)(A)(ii). For purposes of the application of section 409A to a plan to which section 457 applies, a payment under the plan generally means the provision of cash or property to the service provider, provided that for purposes of the application of the short-term deferral rule set forth in paragraph (b)(4) of this section, the inclusion in income of an amount under section 457(f) is treated as a payment of the amount.

(5)Certain welfare benefits. The term nonqualified deferred compensation plan does not include a plan, or a portion of a plan, to the extent that the plan provides bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefits. For these purposes, the terms "disability pay" and "death benefits" have the same meanings as provided in §31.3121(v)(2)-1(b)(4)(iv)(C) of this chapter, provided that for purposes of this paragraph, such disability pay and death benefits may be provided through insurance and the lifetime benefits payable under the plan are not treated as including the value of any taxable term life insurance coverage or taxable disability insurance coverage provided under the plan. The term nonqualified deferred compensation plan also does not include any Archer Medical Savings Account as described in section 220, any Health Savings Account as described in section 223, or any other medical reimbursement arrangement, including a health reimbursement arrangement, that satisfies the requirements of section 105 and section 106 such that the benefits or reimbursements provided under such arrangement are not includible in income.

(b)Deferral of compensation.

(1)In general. Except as otherwise provided in paragraphs (b)(3) through (b)(12) of this section, a plan provides for the deferral of compensation if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable to (or on behalf of) the service provider in a later taxable year. Such compensation is deferred compensation for purposes of section 409A, this section and §§1.409A-2 through 1.409A-6. A legally binding right to an amount that will be excluded from income when and if received does not constitute a deferral of compensation, unless the service provider has received the right in exchange for, or has the right to exchange the right for, an amount that will be includible in income (other than due to participation in a cafeteria plan described in section 125). A service provider does not have a legally binding right to compensation to the extent that compensation may be reduced unilaterally or eliminated by the service recipient or other person after the services creating the right to the compensation have been performed. However, if the facts and circumstances indicate that the discretion to reduce or eliminate the compensation is available or exercisable only upon a condition, or the discretion to reduce or eliminate the

compensation lacks substantive significance, a service provider will be considered to have a legally binding right to the compensation. Whether the discretion to reduce or eliminate the compensation lacks substantive significance depends on all the relevant facts and circumstances. However, where the service provider to whom the compensation may be paid has effective control of the person retaining the discretion to reduce or eliminate the compensation, or has effective control over any portion of the compensation of the person retaining the discretion to reduce or eliminate the compensation, or is a member of the family (as defined in section 267(c)(4) applied as if the family of an individual includes the spouse of any member of the family) of the person retaining the discretion to reduce or eliminate the compensation, the discretion to reduce or eliminate the compensation will not be treated as having substantive significance. For this purpose, compensation is not considered subject to unilateral reduction or elimination merely because it may be reduced or eliminated by operation of the objective terms of the plan, such as the application of a nondiscretionary, objective provision creating a substantial risk of forfeiture. Similarly, a service provider does not fail to have a legally binding right to compensation merely because the amount of compensation is determined under a formula that provides for benefits to be offset by benefits provided under another plan (including a plan that is qualified under section 401(a)), or because benefits are reduced due to actual or notional investment losses, or, in a final average pay plan, subsequent decreases in compensation.

(2)Earnings. References to the deferral of compensation or deferred compensation include references to earnings. When the right to earnings is specified under the terms of the plan, the legally binding right to earnings arises at the time of the deferral of the compensation to which the earnings relate. A plan may provide that the time and form of payment of earnings is treated separately from the time and form of payment of the underlying compensation, so that, provided that the rules of section 409A are otherwise met, a plan may provide that earnings will be paid at a separate time or in a separate form from the payment of the underlying compensation. For the application of the deferral election rules to current payments of earnings and dividend equivalents, see §1.409A-3(e).

(3)Compensation payable pursuant to the service recipient's customary payment timing arrangement. A deferral of compensation does not occur solely because compensation is paid after the last day of the service provider's taxable year pursuant to the timing arrangement under which the service recipient normally compensates service providers for services performed during a payroll period described in section 3401(b), or with respect to a non-employee service provider, a period not longer than the payroll period described in section 3401(b) or if no such payroll period exists, a period not longer than the earlier of the normal timing arrangement under which the service provider normally compensates non-employee service providers or 30 days after the end of the service provider's taxable year.

(4)Short-term deferrals.

(i) In general. A deferral of compensation does not occur under a plan with respect to any payment (as defined in Sec. 1.409A-2(b)(2)) that is not a deferred payment, provided that the service provider actually or constructively receives such payment on or before the last day of the applicable 2 ½ month period. The following rules apply for purposes of this paragraph (b)(4)(i):

(A) The applicable 2 ½ month period is the period ending on the later of the 15th day of the third month following the end of the service provider's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture or the 15th day of the third month following the end of the service recipient's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture.

(B) A payment is treated as actually or constructively received if the payment is includible in income, including if the payment is includible in income under section 83, the economic benefit doctrine, section 402(b), or section 457(f).

(C) A right to a payment that is never subject to a substantial risk of forfeiture is considered to be no longer subject to a substantial risk of forfeiture on the first date the service provider has a legally binding right to the payment.

(D) A payment is a deferred payment if it is made pursuant to a provision of a plan that provides for the payment to be made or completed on or after any date, or upon or after the occurrence of any event, that will or may occur later than the end of the applicable 2 ½ month period, such as a separation from service, death, disability, change in control event, specified time or schedule of payment, or unforeseeable emergency, regardless of whether an amount is actually paid as a result of the occurrence of such a payment date or event during the applicable 2 ½ month period. If a plan provides that the service provider or service recipient may make an election under the plan (including an election under §1.409A-2(a)(4)) of a different payment date, schedule, or event, such right is disregarded for this purpose. In such cases, whether a plan provides for a deferred payment is determined based on the payment date, schedule, or event that would apply if no such election were made, except that if the plan would not provide for a deferred payment absent such an election, and the service provider or service recipient makes such an election, whether the plan provides for a deferred payment is determined based upon the payment date, schedule, or event that the service provider or service recipient in fact elected.

(E) A stock right provides for a deferred payment if such right includes any provision pursuant to which the holder of the stock right will or may have the right to exercise the stock right after the applicable 2 ½ month period.

(F) This paragraph (b)(4)(i) is applied separately to each payment (as defined in §1.409A-2(b)(2)) required to be made under a plan.

(G) If a plan provides for a deferred payment with respect to part of a payment (for example a life annuity or a series of installment amounts treated as a single payment), the plan provides for a deferred payment with respect to the entire payment.

(ii) Certain delayed payments. A payment that otherwise qualifies as a short-term deferral under paragraph (b)(4)(i) of this section but is made after the applicable 2 ½ month period may continue to qualify as a short-term deferral if the taxpayer establishes that it was administratively impracticable to make the payment by the end of the applicable 2 ½ month period and, as of the date upon which the legally binding right to the compensation arose, such impracticability was unforeseeable, or the taxpayer establishes that making the payment by the end of the applicable 2 ½ month period would have jeopardized the ability of the service recipient to continue as a going concern, and provided further that the payment is made as soon as administratively practicable or as soon as the payment would no longer have such effect. For purposes of this paragraph (b)(4)(ii), an action or failure to act of the service provider or a person under the service provider's control, such as a failure to provide necessary information or documentation, is not an unforeseeable event. In addition, a payment that otherwise qualifies as a short-term deferral under paragraph (b)(4)(i) of this section but is made after the applicable 2 ½ month period may continue to qualify as a short-term deferral if the taxpayer establishes that the service recipient reasonably anticipated that the service recipient's deduction with respect to such payment otherwise would not be permitted by application of section 162(m), and, as of the date the legally binding right to the payment arose, a reasonable person would not have anticipated the application of section 162(m) at the time of the payment, and provided further that the payment is made as soon as reasonably practicable following the first date on which the service recipient anticipates or reasonably should anticipate that, if the payment were made on such date, the service recipient's deduction with respect to such payment would no longer be restricted due to the application of section 162(m). For additional rules applicable to certain transaction-based compensation, see §1.409A-3(i)(5)(iv)(A).

(iii) Examples. The following examples illustrate the provisions of this paragraph (b)(4). In these examples, except as otherwise noted, each employee and each employer has a calendar year taxable year and each employee is an individual who is employed by the specified employer.

Example (1). On November 1, 2008, Employer Z awards a bonus to Employee A such that Employee A has a legally binding right to the payment as of November 1, 2008, that is not subject to a substantial risk of forfeiture. The bonus plan does not provide for a payment date or a deferred payment. The bonus plan will not be considered to have provided for a deferral of compensation if the bonus is paid or made available to Employee A on or before March 15, 2009.

Example (2). Employer Y has a taxable year ending August 31. On November 1, 2008, Employer Y awards a bonus to Employee B so that Employee B has a legally binding right to the payment as of November 1, 2008, that is not subject to a substantial risk of forfeiture. The bonus plan does not provide for a payment date or a deferred payment. The bonus plan will not be considered to have provided for a deferral of compensation if the bonus is paid or made available to Employee B on or before November 15, 2009.

Example (3). On November 1, 2008, Employer X awards a bonus to Employee C such that Employee C has a legally binding right to the payment as of November 1, 2008. Under the bonus plan, Employee C will forfeit the bonus unless Employee C continues

performing services through December 31, 2010. The right to the payment is subject to a substantial risk of forfeiture through December 31, 2010. Employee C has the right to make a written election not later than December 31, 2009, to receive the bonus on or after December 31, 2015, but Employee C does not make such election. The bonus plan does not provide for a default payment date or a deferred payment in the absence of an election by Employee C. The bonus plan will not be considered to have provided for a deferral of compensation if the bonus is paid or made available to Employee C on or before March 15, 2011.

Example (4). On November 1, 2008, Employer W awards a bonus to Employee D such that Employee D has a legally binding right to the payment as of November 1, 2008. Under the bonus plan, the bonus will be determined based on services performed during the period from January 1, 2009 through December 31, 2010. The bonus is scheduled to be paid as a lump sum payment on February 15, 2011. Under the bonus plan, Employee D will forfeit the bonus unless Employee D continues performing services through the scheduled payment date (February 15, 2011). Provided that at all times before the scheduled payment date Employee D is required to continue to perform services to retain the right to the bonus, and the bonus is paid on or before March 15, 2012, the bonus plan will not be considered to have provided for a deferral of compensation.

Example (5). On November 1, 2008, Employer V awards a bonus to Employee E such that Employee E has a legally binding right to the payment as of November 1, 2008. Under the bonus plan, Employee E will forfeit the bonus unless Employee E continues performing services through December 31, 2010. Under the bonus plan, the bonus is scheduled to be paid as a lump sum payment on July 1, 2011. By specifying a payment date after the applicable 2 ½ month period, the bonus plan provides for a deferred payment. The bonus plan provides for a deferral of compensation, and will not qualify as a short-term deferral regardless of whether the bonus is paid or made available on or before March 15, 2011 (and generally any payment before June 1, 2011 would constitute an impermissible acceleration of a payment).

Example (6). On November 1, 2008, Employer U awards a bonus to Employee F such that Employee F has a legally binding right to the payment as of November 1, 2008, that is not subject to a substantial risk of forfeiture. The bonus plan provides for a lump sum payment upon Employee F's separation from service. Because the separation from service is an event that may occur after the applicable 2 ½ month period, the bonus plan provides for a deferred payment and therefore provides for a deferral of compensation. Accordingly, the bonus plan will not qualify as a short-term deferral regardless of whether Employee F separates from service and the bonus is paid or made available on or before March 15, 2009.

Example (7). On November 1, 2008, Employer T grants Employee G a legally binding right to the payment of a life annuity with the first annuity payment on November 1, 2013, provided that Employee G continues performing services for Employer T continuously through November 1, 2013. Because the life annuity is treated as a single payment, and because all payments of the life annuity may not occur during the applicable 2 ½ month period, the plan provides for a deferred payment and none of the amounts payable under the annuity will qualify as a short-term deferral, so that section 409A applies to all amounts that are payable under the plan.

Example (8). On November 1, 2008, Employer S grants Employee H a stock right providing for an exercise price less than the fair market value of the underlying stock on November 1, 2008. The stock right is subject to a substantial risk of forfeiture requiring services through November 1, 2010. The stock right becomes exercisable when the substantial risk of forfeiture lapses and expires on November 1, 2013. Employee H continues providing services through November 1, 2010, at which time the substantial risk of forfeiture lapses. The stock right provides for a deferred payment and will not qualify as a short-term deferral regardless of whether Employee H exercises the stock right on or before March 15, 2011.

(5) Stock options, stock appreciation rights, and other equity-based compensation.

(i) Stock rights.

(A) Nonstatutory stock options not providing for the deferral of compensation. An option to purchase service recipient stock does not provide for a deferral of compensation if-

(1) The exercise price may never be less than the fair market value of the underlying stock (disregarding lapse restrictions as defined in §1.83-3(i)) on the date the option is granted and the number of shares subject to the option is fixed on the original date of grant of the option;

(2) The transfer or exercise of the option is subject to taxation under section 83 and §1.83-7; and

(3) The option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of the following:

(i) The exercise or disposition of the option under §1.83-7.

(ii) The time the stock acquired pursuant to the exercise of the option first becomes substantially vested (as defined in §1.83-3(b)).

(B) Stock appreciation rights not providing for the deferral of compensation. A right to compensation based on the appreciation in value of a specified number of shares of service recipient stock occurring between the date of grant and the date of exercise of such right (a stock appreciation right) does not provide for a deferral of compensation if-

(1) Compensation payable under the stock appreciation right cannot be greater than the excess of the fair market value of the stock (disregarding lapse restrictions as defined in §1.83-3(i)) on the date the stock appreciation right is exercised over an amount specified on the date of grant of the stock appreciation right (the stock appreciation right exercise price), with respect to a number of shares fixed on or before the date of grant of the right;

(2) The stock appreciation right exercise price may never be less than the fair market value of the underlying stock (disregarding lapse restrictions as defined in §1.83-3(i)) on the date the right is granted; and

(3) The stock appreciation right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the stock appreciation right.

(C) Stock rights that may provide for the deferral of compensation. An option to purchase stock other than service recipient stock, or a stock appreciation right with respect to stock other than service recipient stock, generally will provide for the deferral of compensation within the meaning of this paragraph (b). If under the terms of an option to purchase service recipient stock (other than an incentive stock option described in section 422 or a stock option granted under an employee stock purchase plan described in section 423), the exercise price is or could become less than the fair market value of the stock (disregarding lapse restrictions as defined in § 1.83-3(i)) on the date of grant, the grant of the option generally will provide for the deferral of compensation within the meaning of this paragraph (b). If under the terms of a stock appreciation right with respect to service recipient stock, the compensation payable under the stock appreciation right is or could be any amount greater than, with respect to a predetermined number of shares, the excess of the fair market value of the stock (disregarding lapse restrictions as defined in § 1.83-3(i)) on the date the stock appreciation right is exercised over the fair market value of the stock (disregarding lapse restrictions as defined in § 1.83-3(i)) on the date of grant of the stock appreciation right, the grant of the stock appreciation right generally will provide for a deferral of compensation within the meaning of this paragraph (b).

(D) Feature for the deferral of compensation. To the extent a stock right provides a right other than the right to receive cash or stock on the date of exercise and such additional right would otherwise allow compensation to be deferred beyond the date of exercise, the entire arrangement (including the underlying stock right) provides for the deferral of compensation. For purposes of this paragraph (b)(5)(i), neither the right to receive substantially nonvested stock (as defined in § 1.83-3(b)) upon the exercise of a stock right, nor the right to pay the exercise price with previously acquired shares, constitutes a feature for the deferral of compensation.

(E) Rights to dividends. For purposes of this paragraph (b)(5)(i), the right, directly or indirectly contingent upon the exercise of a stock right, to receive an amount equal to all or part of the dividends or other distributions (other than stock dividends described in paragraph (b)(5)(v)(H) of this section) declared and paid on the number of shares underlying the stock right between the date of grant and the date of exercise of the stock right constitutes an offset to the exercise price of the stock option or an increase in the amount payable under the stock appreciation right (generally causing such stock right to be subject to section 409A). A plan providing a right to dividends or other distributions declared and paid on the number of shares underlying a stock right, the payment of which is not contingent upon, or otherwise payable on, the exercise of the stock right, may provide for a deferral of compensation, but the existence of the right to receive such an amount will not be treated as a reduction to the exercise price of (or an increase to the compensation payable under) the stock right. Thus, a right to such dividends or distributions that is not contingent, directly or indirectly, upon the exercise of a

stock right will not cause the related stock right to fail to satisfy the requirements of the exclusion from the definition of a deferral of compensation provided in paragraphs (b)(5)(i)(A) and (B) of this section.

(ii) Statutory stock options. The grant of an incentive stock option as described in section 422, or the grant of an option under an employee stock purchase plan described in section 423 (including the grant of an option with an exercise price discounted in accordance with section 423(b)(6) and the accompanying regulations), does not constitute a deferral of compensation. However, the exclusion for statutory stock options under this paragraph (b)(5)(ii) does not apply to a modification, extension, or renewal of a statutory option that is treated as the grant of a new option that is not a statutory option. See §1.424-1(e). In such event, the option is treated for purposes of this paragraph (b) as if it had been a nonstatutory stock option from the date of the original grant. Accordingly, if such modification, extension, or renewal of the stock option would have been treated as the grant of a new option or as causing the option to have had a deferral feature from the date of grant under paragraph (b)(5)(v) of this section, the modification, extension, or renewal of the stock option is treated as the grant of a new option or as causing the option to have had a deferral feature from the date of grant for purposes of this paragraph (b)(5).

(iii) Service recipient stock.

(A) In general. Except as otherwise provided in paragraphs (b)(5)(iii)(B), (C), and (D) of this section, the term service recipient stock means a class of stock that, as of the date of grant, is common stock for purposes of section 305 and the regulations thereunder of a corporation that is an eligible issuer of service recipient stock (as defined in paragraph (b)(5)(iii)(E) of this section).

Notwithstanding the foregoing, the term service recipient stock does not include a class of stock that has any preference as to distributions other than distributions of service recipient stock and distributions in liquidation of the issuer. The term service recipient stock also does not include any stock that is subject to a mandatory repurchase obligation (other than a right of first refusal), or a put or call right that is not a lapse restriction as defined in §1.83-3(i), if the stock price under such right or obligation is based on a measure other than the fair market value (disregarding lapse restrictions as defined in §1.83-3(i)) of the equity interest in the corporation represented by the stock.

(B) American depositary receipts. An American depositary receipt or American depositary share may constitute service recipient stock, to the extent that the stock traded on a foreign securities market to which the American depositary receipt or American depositary share relates qualifies as service recipient stock.

(C) Mutual company units. Mutual company units may constitute service recipient stock. For this purpose, the term mutual company unit means a fixed percentage of the overall value of a non-stock mutual company or association. For purposes of determining the value of the mutual company unit, the unit may be valued in accordance with the rules set forth in paragraph (b)(5)(iv)(B) of this section governing valuation of service recipient stock the shares of which are not traded on an established securities market, applied as if the mutual company were a stock corporation with one class of common stock and the number of shares of such stock determined according to such fixed percentage. For example, an

appreciation right based on the appreciation of 10 mutual company units, where each unit is defined as one percent of the overall value of the mutual company, would be valued as if the appreciation right were based upon 10 shares of a corporation, with 100 shares of common stock (and no other class of stock), the shares of which are not readily tradable on an established securities market.

(D) Other entities. An interest in an entity other than a corporation or non-stock mutual company or association may constitute service recipient stock to the extent designated by the Commissioner in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(E) Eligible issuer of service recipient stock.

(1) In general. The term eligible issuer of service recipient stock means only the corporation for which the service provider provides direct services on the date of grant of the stock right (if the entity receiving such services is a corporation), and any corporation in a chain of corporations or other entities in which each corporation or other entity has a controlling interest in another corporation or other entity in the chain, ending with the corporation or other entity that has a controlling interest in the corporation or other entity for which the service provider provides direct services on the date of grant of the stock right. For this purpose, the term controlling interest has the same meaning as provided in §1.414(c)-2(b)(2)(i), provided that the language "at least 50 percent" is used instead of "at least 80 percent" each place it appears in §1.414(c)-2(b)(2)(i). In addition, where the use of such stock with respect to the grant of a stock right to such service provider is based upon legitimate business criteria, the term controlling interest has the same meaning as provided in §1.414(c)-2(b)(2)(i), provided that the language "at least 20 percent" is used instead of "at least 80 percent" each place it appears in § 1.414(c)-2(b)(2)(i). For purposes of determining ownership of an interest in an organization, the rules of §§1.414(c)-3 and 1.414(c)-4 apply. The determination of whether a grant is based on legitimate business criteria is based on the facts and circumstances, focusing primarily on whether there is a sufficient nexus between the service provider and the issuer of the stock right so that the grant serves a legitimate non-tax business purpose other than simply providing compensation to the service provider that is excluded from the requirements of section 409A. For example, stock of a corporation that owns an interest in a joint venture involving an operating business, used with respect to stock rights granted to service providers of the joint venture who are former service providers of such corporation, generally will constitute use of service recipient stock based upon legitimate business criteria, and therefore could constitute service recipient stock with respect to such service providers if the corporation owns at least 20 percent of the joint venture and the other requirements of this paragraph (b)(5)(iii) are met. Similarly, the legitimate business criteria requirement generally would be met if the corporate venturer issued such a right to an employee of the joint venture who it reasonably expected would in the future become an employee of the corporate venturer. However, where a service provider has no real nexus with a corporate venturer, such as

generally happens when the corporate venturer is a passive investor in the service recipient joint venture, a stock right issued to that employee on the investor corporation's stock generally would not be based upon legitimate business criteria. Similarly, where a corporation holds only a minority interest in an entity that in turn holds a minority interest in the entity for which the service provider performs services, such that the corporation holds only an insubstantial indirect interest in the entity receiving the services, legitimate business criteria generally would not exist for issuing a stock right on the corporation's stock to the service provider.

(2) Investment vehicles. Notwithstanding the provisions of paragraph (b)(5)(iii)(E)(1) of this section, except as to a service provider providing services directly to such corporation, for purposes of this paragraph (b)(5), an eligible issuer of service recipient stock does not include any corporation whose primary purpose is to serve as an investment vehicle with respect to the corporation's minority ownership interests in entities other than the service recipient.

(3) Corporate structures established or transactions undertaken for purposes of avoiding coverage under section 409A. Notwithstanding the provisions of paragraph (b)(5)(iii)(E)(1) of this section, an eligible issuer of service recipient stock does not include any corporation within a group of entities treated as a single service recipient if a purpose of the establishment of the structure of the ownership, or a purpose of a significant transaction between or among two or more entities comprising a single service recipient, is to provide deferred compensation not subject to the application of section 409A. If an entity becomes a member of a group of corporations or other entities treated as a single service recipient, and the primary source of income or value of such entity arises from the provision of management services to other members of the service recipient group, it is presumed that such structure was established for purposes of avoiding the application of section 409A if any stock rights are issued with respect to such entity.

(4) Substitutions and assumptions by reason of a corporate transaction. If the requirements of paragraph (b)(5)(v)(D) of this section are met such that the substitution of a new stock right pursuant to a corporate transaction for an outstanding stock right, or the assumption of an outstanding stock right pursuant to a corporate transaction, would not be treated as the grant of a new stock right or a change in the form of payment for purposes of this section and §§1.409A-2 through 1.409A-6, the stock underlying the stock right that replaced the stock right that is substituted or assumed will be treated as service recipient stock for purposes of applying this paragraph (b)(5) to the replacement stock rights if such underlying stock otherwise satisfies the requirements of paragraph (b)(5)(iii)(A) of this section. For example, if by reason of a spinoff transaction (under which the stock of a subsidiary corporation is distributed to the stockholders of a distributing corporation), a stock option to purchase distributing corporation stock is replaced with a stock

option to purchase distributing corporation stock and a stock option to purchase the spun off subsidiary corporation's stock (each otherwise satisfying the requirements of paragraph (b)(5)(iii)(A) of this section), and where such substitution is not treated as a modification of the original stock option pursuant to paragraph (b)(5)(v)(D) of this section, both the distributing corporation stock and the subsidiary corporation stock are treated as service recipient stock for purposes of applying this paragraph (b)(5) to the replacement stock options.

(iv) Determination of the fair market value of service recipient stock.

(A) Stock readily tradable on an established securities market. For purposes of paragraph (b)(5)(i) of this section, in the case of service recipient stock that is readily tradable on an established securities market, the fair market value of the stock may be determined based upon 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, the arithmetic mean of the high and low prices on the trading day before or the trading day of the grant, or any other reasonable method using actual transactions in such stock as reported by such market. The determination of fair market value also may be determined using an average selling price during a specified period that is within 30 days before or 30 days after the applicable valuation date, provided that the program under which the stock right is granted, including a program with a single participant, must irrevocably specify the commitment to grant the stock right with an exercise price set using such an average selling price before the beginning of the specified period. For this purpose, the term average selling price refers to the arithmetic mean of such selling prices on all trading days during the specified period, or the average of such prices over the specified period weighted based on the volume of trading of such stock on each trading day during such specified period. To satisfy this requirement, the service recipient must designate the recipient of the stock right, the number and class of shares of stock that are subject to the stock right, and the method for determining the exercise price including the period over which the averaging will occur, before the beginning of the specified averaging period. Notwithstanding the forgoing provisions of this paragraph (b)(5)(iv)(A), where applicable foreign law requires that a compensatory stock right be priced based upon a specific price averaging method and period, a stock right granted in accordance with such applicable foreign law will be treated as meeting the requirements of this paragraph (b)(5)(iv)(A), provided that the averaging period does not exceed 30 days.

(B) Stock not readily tradable on an established securities market.

(1) In general. For purposes of paragraph (b)(5)(i) of this section, in the case of service recipient stock that is not readily tradable on an established securities market, the fair market value of the stock as of a valuation date means a value determined by the reasonable application of a reasonable valuation method. The determination whether a valuation method is reasonable, or whether an application of a valuation method is reasonable, is made based on the facts and circumstances as of the valuation date. Factors to be considered under a reasonable valuation method include, as applicable, 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 interests 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 whether the valuation method is used for other purposes that have a material economic effect on the service recipient, its stockholders, or its creditors. The use of a valuation method is not reasonable if such valuation method does not take into consideration in applying its methodology all available information material to the value of the corporation. Similarly, the use of a value previously calculated under a valuation method is not reasonable as of a later date if such calculation fails to reflect information available after the date of the calculation that may materially affect the value of the corporation (for example, the resolution of material litigation or the issuance of a patent) or the value was calculated with respect to a date that is more than 12 months earlier than the date for which the valuation is being used. The service recipient's consistent use of a valuation method to determine the value of its stock or assets for other purposes, including for purposes unrelated to compensation of service providers, is also a factor supporting the reasonableness of such valuation method.

(2) Presumption of reasonableness. For purposes of this paragraph (b)(5)(iv)(B), the use of any of the following methods of valuation is presumed to result in a reasonable valuation, provided that the Commissioner may rebut such a presumption upon a showing that either the valuation method or the application of such method was grossly unreasonable:

(i) A valuation of a class of stock determined by an independent appraisal that meets the requirements of section 401(a)(28)(C) and the regulations as of a date that is no more than 12 months before the relevant transaction to which the valuation is applied (for example, the date of grant of a stock option).

(ii) A valuation based upon a formula that, if used as part of a nonlapse restriction (as defined in Sec. 1.83-3(h)) with respect to the stock, would be considered to be the fair market value of the stock pursuant to Sec. 1.83-5, provided that such stock is valued in the same manner for purposes of any transfer of any shares of such class of stock (or any substantially similar class of stock) to the issuer or any person that owns stock possessing more than 10 percent of the total combined voting power of all classes of stock of the issuer (applying the stock attribution rules of Sec. 1.424-1(d)), other than an arm's length transaction involving the sale of all or substantially all of the outstanding stock of the issuer, and such valuation method is used consistently for all such purposes,

and provided further that this paragraph (b)(5)(iv)(B)(2)(ii) does not apply with respect to stock subject to a stock right payable in stock, where the stock acquired pursuant to the exercise of the stock right is transferable other than through the operation of a nonlapse restriction.

(iii) A valuation, made reasonably and in good faith and evidenced by a written report that takes into account the relevant factors described in paragraph (b)(5)(iv)(B)(1) of this section, of illiquid stock of a start-up corporation. For this purpose, illiquid stock of a start-up corporation means service recipient stock of a corporation that has no material trade or business that it or any predecessor to it has conducted for a period of 10 years or more and has no class of equity securities that are traded on an established securities market (as defined in paragraph (k) of this section), where such stock is not subject to any put, call, or other right or obligation of the service recipient or other person to purchase such stock (other than a right of first refusal upon an offer to purchase by a third party that is unrelated to the service recipient or service provider and other than a right or obligation that constitutes a lapse restriction as defined in §1.83-3(i)), and provided that this paragraph (b)(5)(iv)(B)(2)(iii) does not apply to the valuation of any stock if the service recipient or service provider may reasonably anticipate, as of the time the valuation is applied, that the service recipient will undergo a change in control event as described in §1.409A-3(i)(5)(v) or §1.409A-3(i)(5)(vii) within the 90 days following the action to which the valuation is applied, or make a public offering of securities within the 180 days following the action to which the valuation is applied. For purposes of this paragraph (b)(5)(iv)(B)(2)(iii), a valuation will not be treated as made reasonably and in good faith unless the valuation is performed by a person or persons that the corporation reasonably determines is qualified to perform such a valuation based on the person's or persons' significant knowledge, experience, education, or training. Generally, a person will be qualified to perform such a valuation if a reasonable individual, upon being apprised of such knowledge, experience, education, and training, would reasonably rely on the advice of such person with respect to valuation in deciding whether to accept an offer to purchase or sell the stock being valued. For this purpose, significant experience generally means at least five years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry in which the service recipient operates.

(3) Use of alternative methods. For purposes of this paragraph (b)(5), a different valuation method may be used for each separate action for which a valuation is relevant, provided that a single valuation method is used for each separate action and, once used, may not retroactively be altered. For

example, one valuation method may be used to establish the exercise price of a stock option, and a different valuation method may be used to determine the value at the date of the repurchase of stock pursuant to a put or call right. However, once an exercise price or amount to be paid has been established, the exercise price or amount to be paid may not be changed through the retroactive use of another valuation method. In addition, notwithstanding the foregoing, where after the date of grant, but before the date of exercise or transfer, of the stock right, the service recipient stock to which the stock right relates becomes readily tradable on an established securities market, the service recipient must use the valuation method set forth in paragraph (b)(5)(iv)(A) of this section for purposes of determining the payment at the date of exercise or the purchase of the stock, as applicable.

(v) Modifications, extensions, substitutions, and assumptions of stock rights.

(A) Treatment of modified and extended stock rights. A modification of the terms of a stock right within the meaning of paragraph (b)(5)(v)(B) of this section is considered to be the grant of a new stock right. The new stock right may or may not constitute a deferral of compensation under paragraph (b)(5)(i) of this section, determined at the date of grant of the new stock right. If there is an extension of a stock right (within the meaning of paragraph (b)(5)(v)(C) of this section), the stock right is treated as having had an additional deferral feature from the original date of grant of the stock right, and therefore will be treated as a plan providing for the deferral of compensation from the original grant date for purposes of this paragraph (b).

(B) Modification in general. Except as otherwise provided in paragraph (b)(5)(v) of this section, the term modification means any change in the terms of the stock right (or change in the terms of the plan pursuant to which the stock right was granted or in the terms of any other agreement governing the stock right) that may provide the holder of the stock right with a direct or indirect reduction in the exercise price of the stock right regardless of whether the holder in fact benefits from the change in terms. A change in the terms of the stock right shortening the period during which the stock right is exercisable is not a modification. It is not a modification to add a feature providing the ability to tender previously acquired stock for the stock purchasable under the stock right, or to withhold or have withheld shares of stock to facilitate the payment of the exercise price or the employment taxes or required withholding taxes resulting from the exercise of the stock right. In addition, it is not a modification for the grantor to exercise discretion specifically reserved under a stock right with respect to the transferability of the stock right.

(C) Extensions.

(1) In general. An extension of a stock right refers to the provision to the holder of an additional period of time within which to exercise the stock right beyond the time originally prescribed under the terms of the stock right, the conversion or exchange of a stock right for a legally binding right to compensation in a future taxable year, or the addition of any feature for the deferral of compensation not permitted in paragraph

(b)(5)(i)(A)(3) of this section (in the case of a stock option) or not permitted in paragraph (b)(5)(i)(B)(3) of this section (in the case of a stock appreciation right) to the terms of the stock right, other than at a time when the exercise price of the stock right equals or exceeds the fair market value of the service recipient stock that could be purchased (in the case of an option) or the fair market value of the service recipient stock used to determine the payment to the service provider (in the case of a stock appreciation right), and includes a renewal of such right that has such effect. It is not an extension if the exercise period of a stock right is extended to a date no later than the earlier of the latest date upon which the stock right could have expired by its original terms under any circumstances or the 10th anniversary of the original date of grant of the stock right. If the exercise period of a stock right is extended at a time when the exercise price of the stock right equals or exceeds the fair market value of the service recipient stock that could be purchased (in the case of an option) or the fair market value of the service recipient stock used to determine the payment to the service provider (in the case of a stock appreciation right), it is not an extension of the original stock right. Instead, in such a case, the original stock right is treated as modified rather than extended and a new stock right is treated as having been granted for purposes of this section. In addition, it is not an extension of a stock right if the expiration of the stock right is tolled while the holder cannot exercise the stock right because such an exercise would violate an applicable Federal, state, local, or foreign law, or would jeopardize the ability of the service recipient to continue as a going concern, provided that the period during which the stock right may be exercised is not extended more than 30 days after the exercise of the stock right first would no longer violate an applicable Federal, state, local, and foreign laws or would first no longer jeopardize the ability of the service recipient to continue as a going concern. For this purpose, a provision of foreign law shall be considered applicable only to foreign earned income (as defined under section 911(b)(1) without regard to section 911(b)(1)(B)(iv) and without regard to the requirement that the income be attributable to services performed during the period described in section 911(d)(1)(A) or (B)) from sources within the foreign country that promulgated such law.

(2) Certain extensions before April 10, 2007. An extension of a stock right before April 10, 2007 solely in order to provide the holder of such stock right an additional period of time beyond the time originally prescribed under the terms of such stock right within which to exercise the stock right is disregarded for purposes of applying the rules contained in paragraph (b)(5)(v)(C)(1) of this section. For purposes of applying the rules contained in paragraph (b)(5)(v)(C)(1) of this section on and after April 10, 2007, such a stock right is treated as having specified at the date of grant the time within which to exercise such stock right that was prescribed under the terms of such stock right in effect on April 10, 2007. Nothing in this paragraph (b)(5)(v)(C)(2) affects any other action treated as the extension of a stock right, including the addition of a deferral feature.

(3) Examples. The following examples illustrate the provisions of this paragraph (b)(5)(v)(C). In the examples, each employee is an individual employed by the specified employer, and each employee and each employer has a calendar year taxable year.

Example (1). On July 1, 2009, Employer Z grants Employee A a nonstatutory stock option that does not provide for the deferral of compensation in accordance with paragraph (b)(5)(i)(A) of this section. The terms of the nonstatutory stock option provide that the exercise period of the stock option expires on the earlier of July 1, 2019, or 3 months after Employee A's separation from service. On July 1, 2011, Employee A separates from service. On the same day, Employee A and Employer Z change the exercise period of the option so that it expires on July 1, 2013. Because the exercise period of the stock right is not extended beyond July 1, 2019, the change is not an extension for purposes of this paragraph (b)(5)(v)(C).

Example (2). The facts are the same as in Example 1 except that Employee A separates from service on July 1, 2018, and on the same day, Employee A and Employer Z change the exercise period of the option so that it expires on July 1, 2020. As of July 1, 2018, the fair market value of the underlying stock exceeds the exercise price. Because the exercise period of the stock right is extended beyond July 1, 2019, the change is an extension for purposes of this paragraph (b)(5)(v)(C).

Example (3). The facts are the same as in Example 2 except that as of July 1, 2018, the fair market value of the underlying stock is less than the exercise price of the option. Because the exercise period of the stock right is extended at a time when the fair market value of the underlying stock is less than the exercise price, the change is not an extension for purposes of this paragraph (b)(5)(v)(C) and the change is treated as a modification of the option, resulting in the extension of the exercise period being treated as the grant of a new option on July 1, 2018.

Example (4). On July 1, 2009, Employer Y grants to Employee B a stock appreciation right with respect to 200 shares of Employer Y common stock that does not provide for the deferral of compensation in accordance with paragraph (b)(5)(i)(B) of this section. Upon exercise of the stock appreciation right, Employee B is entitled to receive the excess of the fair market value of a share of Employer Y common stock on the date of exercise over \$100 (the fair market value of a share of Employer Y common stock on July 1, 2009), multiplied by the number of shares with respect to which Employee B is exercising the right. The exercise period of the right expires on the earlier of July 1, 2019, or 3 months after Employee B separates from service. Employee B cannot exercise the stock appreciation right with respect to more than 100 shares unless Employee B continues to be employed by Employer Y through June 30, 2014. On July 1, 2011, when the fair market value of a share of Employer Y common

stock is \$200, Employee B and Employer Y amend the stock appreciation right to provide that the right will be exercisable only during calendar year 2018, except that before January 1, 2017, Employee B may elect to designate calendar year 2023 or any subsequent calendar year before 2033 as the year in which the right will be exercisable. The amendment constitutes an extension of the stock appreciation right under paragraph (b)(5)(v)(C)(1) of this section. Under paragraph (b)(5)(v)(A) of this section, the stock appreciation right is treated as having had an additional deferral feature from the original date of grant (July 1, 2009) of the right, and therefore is treated as a plan providing for the deferral of compensation from that date. During the period from July 1, 2009, through June 30, 2011, the provisions of the stock appreciation right relating to the time and form of payment did not satisfy the requirements of § 1.409A-3(a). Therefore, the stock appreciation right provides for a deferral of compensation that does not comply with section 409A.

(D) Substitutions and assumptions of stock rights by reason of a corporate transaction. If the requirements of § 1.424-1 (without regard to the requirement described in § 1.424-1(a)(2) that an eligible corporation be the employer of the optionee) would be met if the stock right were a statutory option, the substitution of a new stock right pursuant to a corporate transaction (as defined in § 1.424-1(a)(3)) for an outstanding stock right or the assumption of an outstanding stock right pursuant to a corporate transaction will not be treated as the grant of a new stock right or a change in the form of payment for purposes of this section and §§ 1.409A-2 through 1.409A-6. For purposes of the preceding sentence, the requirement of § 1.424-1(a)(5)(iii) will be deemed to be satisfied if the ratio of the exercise price to the fair market value of the shares subject to the stock right immediately after the substitution or assumption is not greater than the ratio of the exercise price to the fair market value of the shares subject to the stock right immediately before the substitution or assumption. In the case of a transaction described in section 355 in which the stock of the distributing corporation and the stock distributed in the transaction are both readily tradable on an established securities market immediately after the transaction, for purposes of this paragraph (b)(5)(v), the requirements of § 1.424-1(a)(5) related to the fair market value of the stock may be satisfied by-

- (1) Using the last sale before or the first sale after the specified date as of which such valuation is being made, the closing price on the last trading day before or the trading day of a specified date, the arithmetic mean of the high and low prices on the last trading day before or the trading day of such specified date, or any other reasonable method using actual transactions in such stock as reported by such market on a specified date, for the stock of the distributing corporation and the stock distributed in the transaction, provided the specified date is designated before such specified date, and such specified date is not more than 60 days after the transaction;
- (2) Using the arithmetic mean of such market prices on trading days during a specified period designated before the beginning of such specified period, where such specified period is not longer than 30 days and ends no later than 60 days after the transaction; or

(3) Using an average of such prices during such prespecified period weighted based on the volume of trading of such stock on each trading day during such prespecified period.

(E) Acceleration of date when exercisable. Although with respect to a stock right not immediately exercisable in full, a change in the terms of the right solely to accelerate or delay, within the original term of the stock right, the time at which the stock right (or any portion of such stock right) may be exercised is not a modification for purposes of this section, with respect to a stock right subject to section 409A, such an acceleration may constitute an impermissible acceleration of a payment date under §1.409A-3(j) or a subsequent deferral under §1.409A-2(b).

(F) Discretionary added benefits. If a change to a stock right provides, either by its terms or in substance, that the holder may receive an additional benefit under the stock right at the future discretion of the grantor, and the addition of such benefit would constitute a modification or extension, then the addition of such discretion is a modification or extension at the time that the stock right is changed to provide such discretion.

(G) Change in underlying stock increasing value. A change in the terms of the stock subject to a stock right that increases the value of the stock is a modification of such stock right, except to the extent that a new stock right is substituted for such stock right by reason of the change in the terms of the stock in accordance with paragraph (b)(5)(v)(D) of this section.

(H) Change in the number of shares purchasable. If a stock right is amended solely to increase the number of shares subject to the stock right, the increase is not considered a modification of the stock right but is treated as the grant of a new additional stock right to which the additional shares are subject. Notwithstanding the previous sentence, if the exercise price and number of shares subject to a stock right are proportionally adjusted to reflect a stock split (including a reverse stock split) or stock dividend, and the only effect of the stock split or stock dividend is to increase (or decrease) on a pro rata basis the number of shares owned by each shareholder of the class of stock subject to the stock right, then there is no modification of the stock right if it is proportionally adjusted to reflect the stock split or stock dividend and the aggregate exercise price of the stock right is not less than the aggregate exercise price before the stock split or stock dividend.

(I) Rescission of changes. A change to the terms of a stock right (or change in the terms of the plan pursuant to which the stock right was granted or in the terms of any other agreement governing the right) is not considered a modification or extension of the stock right to the extent the change in the terms of the stock right is rescinded by the earlier of the date the stock right is exercised or the last day of the service provider's taxable year during which such change occurred. Thus, for example, if the terms of a stock right granted to an individual employee with a calendar year taxable year are changed on March 1 in a manner that would result in an extension of the stock right, and the change is rescinded on November 1 of

the same year, and the stock right is not exercised before the change is rescinded, the stock right is not considered extended under this paragraph (b)(5)(v).

(J) Successive modifications and extensions. The rules of this paragraph (b)(5)(v) apply as well to successive modifications and extensions.

(K) Modifications and extensions in effect on October 23, 2004. For purposes of the application of section 409A and these regulations to a stock right, if a legally binding right to a modification or extension of such stock right existed on October 23, 2004, such modification or extension is disregarded, and the stock right is treated as if granted with the terms and conditions in effect on October 23, 2004.

(vi) Meaning and use of certain terms.

(A) Option. The term option means the right or privilege of an individual to purchase stock from a corporation by virtue of an offer of the corporation continuing for a stated period of time, whether or not irrevocable, to sell such stock at a price determined under paragraph (b)(5)(vi)(D) of this section, such individual being under no obligation to purchase. While no particular form of words is necessary, the option must express an offer to sell at the option price, the maximum number of shares purchasable under the option, and the period of time during which the offer remains open. The term option includes a warrant that meets the requirements of this paragraph (b)(5)(vi)(A). An option may be granted as part of or in conjunction with an employee stock purchase plan or subscription contract. An option must be in writing (in paper or electronic form) provided that such writing is adequate to establish an option right or privilege that is enforceable under applicable law.

(B) Date of grant of option.

(1) The language the date of grant of the option, and similar phrases, refer to the date when the granting corporation completes the corporate action necessary to create the legally binding right constituting the option. A corporate action creating the legally binding right constituting the option is not considered complete until the date on which the maximum number of shares that can be purchased under the option and the minimum exercise price are fixed or determinable, and the class of underlying stock and the identity of the service provider is designated. Ordinarily, if the corporate action provides for an immediate offer of stock for sale to a service provider, or provides for a particular date on which such offer is to be made, the date of the granting of the option is the date of such corporate action if the offer is to be made immediately, or the date provided as the date of the offer, as the case may be. However, an unreasonable delay in the giving of notice of such offer to the service provider will be taken into account as indicating that the corporation provided that the offer was to be made at the subsequent date on which such notice is given.

(2) If the corporation imposes a condition on the granting of an option (as distinguished from a condition governing the exercise of the option), such condition generally will be given effect in accordance with the intent of the corporation. However, if the grant of an option is subject to approval

by stockholders, the date of grant of the option will be determined as if the option had not been subject to such approval. A condition that does not require corporate action, such as the approval of, or registration with, some regulatory or government agency, for example, a stock exchange or the Securities and Exchange Commission, is ordinarily considered a condition upon the exercise of the option unless the corporate action clearly indicates that the option is not to be granted until such condition has been satisfied.

(3) In general, a condition imposed upon the exercise of an option will not operate to make ineffective the granting of the option. For example, on June 1, 2008, Corporation A grants to X, an employee, an option to purchase 5,000 shares of the corporation's common stock, exercisable by X on or after June 1, 2009, provided X is employed by the corporation on June 1, 2009, and provided that A's profits during the fiscal year preceding the year of exercise exceed \$200,000. Such an option is granted to X on June 1, 2008, and will be treated as outstanding as of such date.

(C) Stock. The term stock means capital stock of any class, including voting or nonvoting common or preferred stock. Except as otherwise provided, the term stock includes both treasury stock and stock of original issue. Special classes of stock authorized to be issued to and held by employees are within the scope of the term stock for this purpose, provided such stock otherwise possesses the rights and characteristics of capital stock.

(D) Exercise price. The term exercise price means the consideration in cash or property that, pursuant to the terms of the option, is the price at which the stock subject to the option is purchased. The term exercise price does not include any amounts paid as interest under a deferred payment plan or treated as interest.

(E) Exercise. The term exercise, when used in reference to an option, means the act of acceptance by the holder of the option of the offer to sell contained in the option. In general, the time of exercise is the time when there is a sale or a contract to sell between the corporation and the individual. A promise to pay the exercise price does not constitute an exercise of the option unless the holder of the option is subject to personal liability on such promise. An agreement or undertaking by the service provider to make payments under a stock purchase plan does not constitute the exercise of an option to the extent the payments made remain subject to withdrawal by or refund to the service provider.

(F) Transfer. The term transfer, when used in reference to the transfer to an individual of a share of stock pursuant to the exercise of an option, means the transfer of ownership of such share, or the transfer of substantially all the rights of ownership. Such transfer must, within a reasonable time, be evidenced on the books of the corporation. A transfer may occur even if a share of stock is subject to a substantial risk of forfeiture or is not otherwise transferable immediately after the date of exercise. A transfer does not fail to occur merely because, under the terms of the arrangement, the individual may not dispose of the share for a

specified period of time, or the share is subject to a right of first refusal or a right to acquire the share at the share's fair market value at the time of the sale.

(G) Readily tradable. For purposes of this section and §§ 1.409A-2 through 1.409A-6, stock is treated as readily tradable if it is regularly quoted by brokers or dealers making a market in such stock.

(H) Application to stock appreciation rights. For purposes of this section and §§ 1.409A-2 through 1.409A-6, the definitions provided in paragraphs (b)(5)(vi)(A) through (G) of this section may be applied by analogy to the issuance of, exercise of, or payment upon the exercise of, a stock appreciation right.



(6) Restricted property, section 402(b) trusts, and section 403(c) annuities.

(i) In general. If a service provider receives property from, or pursuant to, a plan maintained by a service recipient, there is no deferral of compensation merely because the value of the property is not includible in income by reason of the property being substantially nonvested (as defined in § 1.83-3(b)), or is includible in income solely due to a valid election under section 83(b). For purposes of this paragraph (b)(6)(i), a transfer of property includes the transfer of a beneficial interest in a trust or annuity plan, or a transfer to or from a trust or under an annuity plan, to the extent such a transfer is subject to section 83, section 402(b) or section 403(c). In addition, for purposes of this paragraph (b), a right to compensation income that will be required to be included in income under section 402(b)(4)(A) is not a deferral of compensation.

(ii) Promises to transfer property. A plan under which a service provider obtains a legally binding right to receive property in a future taxable year where the property will be substantially vested (as defined in § 1.83-3(b)) at the time of transfer of the property may provide for the deferral of compensation and, accordingly, may constitute a nonqualified deferred compensation plan. A legally binding right to receive property in a future taxable year where the property will be substantially nonvested (as defined in § 1.83-3(b)) at the time of transfer of the property will not provide for the deferral of compensation and, accordingly, will not constitute a nonqualified deferred compensation plan unless offered in conjunction with another legally binding right that constitutes a deferral of compensation.

(7) Arrangements between partnerships and partners. [Reserved.]

(8) Certain foreign plans.

(i) Plans with respect to compensation covered by treaty or other international agreement. A plan in which a service provider participates does not provide for a deferral of compensation for purposes of this paragraph (b) to the extent that the compensation under the plan would have been excluded from gross income for Federal income tax purposes under the provisions of any bilateral income tax convention or other bilateral or multilateral agreement to which the United States is a party if the compensation had been paid to the service provider at the time that the legally binding right to the compensation first arose or, if later, the time

that the legally binding right was no longer subject to a substantial risk of forfeiture.

(ii) Plans with respect to certain other compensation. A plan in which a service provider participates does not provide for a deferral of compensation for purposes of this paragraph (b) to the extent that compensation under the plan would not have been includible in gross income for Federal tax purposes if it had been paid to the service provider at the time that the legally binding right to the compensation first arose or, if later, the time that the legally binding right was no longer subject to a substantial risk of forfeiture, due to one of the following:

(A) The service provider was a nonresident alien at such time and the compensation would not have been includible in gross income under section 872.

(B) The service provider was a qualified individual (as defined in section 911(d)(1)) at such time, the compensation would have been foreign earned income within the meaning of section 911(b)(1) (without regard to section 911(b)(1)(B)(iv)) if paid at such time, and the amount of such compensation was equal to or less than the excess (if any) of the maximum exclusion amount under section 911(b)(2)(D) for such taxable year over the amount of foreign earned income actually excluded from gross income by such qualified individual for such taxable year under section 911(a)(1).

(C) The compensation would have been excludible from gross income under section 893.

(D) The compensation would have been excludible from gross income under section 931 or section 933.

(iii) Tax equalization agreements. A tax equalization agreement does not provide for a deferral of compensation if payments made under such tax equalization agreement are made no later than the end of the second taxable year of the service provider beginning after the taxable year of the service provider in which the service provider's U.S. Federal income tax return is required to be filed (including any extensions) for the year to which the compensation subject to the tax equalization payment relates, or, if later, the second taxable year of the service provider beginning after the latest such taxable year in which the service provider's foreign tax return or payment is required to be filed or made for the year to which the compensation subject to the tax equalization payment relates. Where such payments arise due to an audit, litigation or similar proceeding, the right to the payments will not be treated as resulting in a deferral of compensation if the payments are scheduled and made in accordance with the provisions of §1.409A-3(i)(1)(v) (timing of tax gross-up payments). For purposes of this paragraph (b)(8)(iii), the term tax equalization agreement refers to an agreement, method, program, or other arrangement that provides payments intended to compensate the service provider for some or all of the excess of the taxes actually imposed by a foreign jurisdiction on the compensation paid by the service recipient to the service provider over the taxes that would be imposed if the

compensation were subject solely to United States Federal, state, and local income tax, or some or all of the excess of the United States Federal, state, and local income tax actually imposed on the compensation paid by the service to the service provider over the taxes that would be imposed if the compensation were subject solely to taxes in the foreign jurisdiction, provided that the payment made under such agreement, method, program, or other arrangement may not exceed such excess and the amount necessary to compensate for the additional taxes on the amount paid under the agreement, method, program, or other arrangement.

(iv) Certain limited deferrals of a nonresident alien. With respect to a nonresident alien, a foreign plan does not provide for a deferral of compensation if the amounts deferred under the foreign plan based upon services performed by the nonresident alien in the United States (including amounts deferred based upon service credits or compensation received due to services performed in the United States) do not exceed the applicable dollar amount under section 402(g)(1)(B) for the taxable year. If the amounts deferred under the foreign plan based upon the services performed by the nonresident alien in the United States exceed the applicable dollar amount, an amount of such deferrals equal to such amount is treated as not deferred under a nonqualified deferred compensation plan. For purposes of this paragraph (b)(8)(iv), the term foreign plan means a plan that, together with all substantially similar plans, is maintained by a service recipient for a substantial number of participants, substantially all of whom are nonresident aliens or resident aliens classified as resident aliens solely under section 7701(b)(1)(A)(ii) (and not section 7701(b)(1)(A)(i)).

(v) Additional foreign plans. A plan in which a service provider participates does not provide for a deferral of compensation for purposes of this paragraph (b) to the extent designated by the Commissioner in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(vi) Earnings. Earnings on compensation excluded from the definition of deferral of compensation pursuant to this paragraph (b)(8) are also not treated as a deferral of compensation.

(9) Separation pay plans.

(i) In general. A plan that otherwise provides for a deferral of compensation under this paragraph (b) does not fail to provide a deferral of compensation merely because the right to payment of the compensation is conditioned upon a separation from service. However, paragraphs (b)(9)(ii), (iii), (iv), and (v) of this section provide rules concerning the extent to which certain separation pay plans do not provide for the deferral of compensation. The exceptions contained in paragraphs (b)(9)(ii), (iii), (iv), and (v) of this section may be used in combination, such that compensation under a plan that would be excepted under one of those paragraphs may be treated as excepted under another of those paragraphs, so that other compensation under a plan may be treated as excepted under the first of such paragraphs. Notwithstanding any other provision of this paragraph (b)(9), any payment or benefit, or entitlement to a payment or benefit, that acts as a substitute for, or replacement of, amounts deferred by the service

recipient under a separate nonqualified deferred compensation plan constitutes a payment or a deferral of compensation under the separate nonqualified deferred compensation plan, and does not constitute a payment or deferral of compensation under a separation pay plan. If a service provider receives a payment at separation from service and also has a legally binding right to an amount of deferred compensation that would be forfeited upon the separation from service, whether the payment acts as an acceleration of vesting and substitute payment for the amount of deferred compensation forfeited, or whether the deferred compensation is treated as forfeited and the amount paid is treated as a separate payment of current compensation, is determined based on the facts and circumstances, provided that, where the separation from service is voluntary, it is presumed that the payment results from an acceleration of vesting followed by a payment of the deferred compensation that is subject to section 409A. Accordingly, any change in the payment schedule to accelerate or defer the payments would be subject to the rules of section 409A. The presumption that a right to a payment is not a new right, but is instead a right substituted for a pre-existing forfeited right, may be rebutted by demonstrating that the service provider would have obtained the right to the payment regardless of the forfeiture of the nonvested right. A factor indicating that the service provider would have obtained a right to a payment regardless of the forfeiture of the nonvested right is that the amount to which the service provider obtains a right is materially less than an amount equal to the present value of the forfeited amount multiplied by a fraction, the numerator of which is the period of service the service provider actually completed, and the denominator of which is the full period of service the service provider would have been required to complete to receive the full amount of the payment. For example, where a service provider is entitled to a future payment only if the service provider completes three years of service and at the time of termination the service provider has completed one year of service, the presumption could be rebutted if the payment to the service provider is materially less than the present value of one-third of the nonvested amount. Another such factor is that the payment to the service provider is of a type customarily made to service providers who separate from service with the service recipient and do not forfeit nonvested rights to deferred compensation (for example, a payment of accrued but unused leave or a payment for a release of actual or potential claims).

(ii) Collectively bargained separation pay plans. A separation pay plan does not provide for a deferral of compensation to the extent the plan is a collectively bargained separation pay plan that provides for separation pay only upon an involuntary separation from service or pursuant to a window program. Only the portion of the separation pay plan attributable to employees covered by a bona fide collective bargaining agreement is considered to be provided under a collectively bargained separation pay plan. A collectively bargained separation pay plan is a separation pay plan that meets the following conditions:

(A) The separation pay plan is contained within an agreement that the Secretary of Labor determines to be a collective bargaining agreement.

(B) The separation pay provided by the collective bargaining agreement was the subject of arm's length negotiations between employee representatives and one or more employers, and the agreement between

employee representatives and one or more employers satisfies section 7701(a)(46).

(C) The circumstances surrounding the agreement evidence good faith bargaining between adverse parties over the separation pay to be provided under the agreement.

(iii) Separation pay due to involuntary separation from service or participation in a window program. A separation pay plan that is not described in paragraph (b)(9)(ii) of this section and that provides for separation pay only upon an involuntary separation from service (as defined in paragraph (n) of this section) or pursuant to a window program does not provide for a deferral of compensation to the extent that the separation pay, or portion of the separation pay, provided under the plan meets the following requirements:

(A) The separation pay (other than amounts described in paragraphs (b)(9)(iv) and (v) of this section) does not exceed two times the lesser of-

(1) The sum of the service provider's annualized compensation based upon the annual rate of pay for services provided to the service recipient for the taxable year of the service provider preceding the taxable year of the service provider in which the service provider has a separation from service with such service recipient (adjusted for any increase during that year that was expected to continue indefinitely if the service provider had not separated from service); or

(2) The maximum amount that may be taken into account under a qualified plan pursuant to section 401(a)(17) for the year in which the service provider has a separation from service.

(B) The plan provides that the separation pay described in paragraph (b)(9)(iii)(A) of this section must be paid no later than the last day of the second taxable year of the service provider following the taxable year of the service provider in which occurs the separation from service.

(iv) Foreign separation pay plans. A separation pay plan (including a plan providing payments upon a voluntary separation from service) does not provide for deferred compensation to the extent the plan provides for amounts of separation pay required to be provided under the applicable law of a foreign jurisdiction. For this purpose, a provision of foreign law shall be considered applicable only to foreign earned income (as defined under section 911(b)(1) without regard to section 911(b)(1)(B)(iv) and without regard to the requirement that the income be attributable to services performed during the period described in section 911(d)(1)(A) or (B)) from sources within the foreign country that promulgated such law.

(v) Reimbursements and certain other separation payments.

(A) In general. To the extent a separation pay plan (including a plan providing payments upon a voluntary separation from service) entitles a service provider to payment by the service recipient of reimbursements

that are not otherwise excludible from gross income for expenses that the service provider could otherwise deduct under section 162 or section 167 as business expenses incurred in connection with the performance of services (ignoring any applicable limitation based on adjusted gross income), or of reasonable outplacement expenses and reasonable moving expenses actually incurred by the service provider and directly related to the termination of services for the service recipient, such plan does not provide for a deferral of compensation to the extent such rights apply during a limited period of time (regardless of whether such rights extend beyond the limited period of time). For purposes of this paragraph (b)(9)(v)(A), the reimbursement of reasonable moving expenses includes the reimbursement of all or part of any loss the service provider actually incurs due to the sale of a primary residence in connection with a separation from service.

(B) Medical benefits. To the extent a separation pay plan (including a plan providing payments due to a voluntary separation from service) entitles a service provider to reimbursement by the service recipient of payments of medical expenses incurred and paid by the service provider but not reimbursed by a person other than the service recipient and allowable as a deduction under section 213 (disregarding the requirement of section 213(a) that the deduction is available only to the extent that such expenses exceed 7.5 percent of adjusted gross income), such plan does not provide for a deferral of compensation to the extent such rights apply during the period of time during which the service provider would be entitled (or would, but for such plan, be entitled) to continuation coverage under a group health plan of the service recipient under section 4980B (COBRA) if the service provider elected such coverage and paid the applicable premiums.

(C) In-kind benefits and direct service recipient payments. A service provider's entitlement to in-kind benefits from the service recipient, or a payment by the service recipient directly to the person providing the goods or services to the service provider, is treated as not providing for a deferral of compensation for purposes of this paragraph (b), if a right to reimbursement by the service recipient for a payment for such benefits, goods, or services by the service provider would not be treated as providing for a deferral of compensation under this paragraph (b)(9)(v).

(D) Limited payments. If not otherwise excluded, a taxpayer may treat a right or rights under a separation pay plan to a payment or payments as not providing for a deferral of compensation to the extent such payments in the aggregate do not exceed the applicable dollar amount under section 402(g)(1)(B) for the year of the separation from service.

(E) Limited period of time. For purposes of paragraphs (b)(9)(v)(A) and (C) of this section, a limited period of time in which expenses may be incurred, or in which in-kind benefits may be provided by the service recipient or a third party that the service recipient will pay, does not

include periods beyond the last day of the second taxable year of the service provider following the taxable year of the service provider in which the separation from service occurred, provided that the period during which the reimbursements for such expenses must be paid may not extend beyond the third taxable year of the service provider following the taxable year of the service provider in which the separation from service occurred.

(vi) Window programs-definition. The term window program refers to a program established by a service recipient in connection with an impending separation from service to provide separation pay, where such program is made available by the service recipient for a limited period of time (no longer than 12 months) to service providers who separate from service during that period or to service providers who separate from service during that period under specified circumstances. A program will not be considered a window program if a service recipient establishes a pattern of repeatedly providing for similar separation pay in similar situations for substantially consecutive, limited periods of time. Whether the recurrence of these programs constitutes a pattern is determined based on the facts and circumstances. Although no one factor is determinative, relevant factors include whether the benefits are on account of a specific business event or condition, the degree to which the separation pay relates to the event or condition, and whether the event or condition is temporary or discrete or is a permanent aspect of the employer's business.

(10) Certain indemnification and liability insurance plans. A plan in which a service provider participates does not provide for a deferral of compensation for purposes of this paragraph (b) to the extent that the plan provides (to the extent permissible under applicable law), for the indemnification of, or the purchase of an insurance policy providing for payments of, all or part of the expenses incurred or damages paid or payable by a service provider with respect to a bona fide claim against the service provider or service recipient, including amounts paid or payable by the service provider upon the settlement of a bona fide claim against the service provider or service recipient, where such claim is based on actions or failures to act by the service provider in his or her capacity as a service provider of the service recipient.

(11) Legal settlements. An agreement to which a service provider is a party does not provide for a deferral of compensation for purposes of this paragraph (b) to the extent that the agreement provides for amounts paid as settlements or awards resolving bona fide legal claims based on wrongful termination, employment discrimination, the Fair Labor Standards Act, or worker's compensation statutes, including claims under applicable Federal, state, local, or foreign laws, or for reimbursements or payments of reasonable attorneys fees or other reasonable expenses incurred by the service provider related to such bona fide legal claims, regardless of whether such settlements, awards, or reimbursement or payment of expenses pursuant to such claims are treated as compensation or wages for Federal tax purposes. Whether the execution of a waiver of any or all of such types of claims indicates that the amounts are paid as an award or settlement of an actual bona fide claim for damages under applicable law is determined based on the facts and circumstances. This paragraph (b)(11) does not apply to any deferred amounts that did not arise as a result of an actual bona fide claim for damages

under applicable law, such as amounts that would have been deferred or paid regardless of the existence of such claim, even if such amounts are paid or modified as part of a settlement or award resolving an actual bona fide claim. For this purpose, a provision of foreign law shall be considered applicable only to foreign earned income (as defined under section 911(b)(1) without regard to section 911(b)(1)(B)(iv) and without regard to the requirement that the income be attributable to services performed during the period described in section 911(d)(1)(A) or (B)) from sources within the foreign country that promulgated such law.

(12) Certain educational benefits. A plan in which a service provider participates does not provide for a deferral of compensation to the extent the plan provides for taxable educational benefits. For purposes of this paragraph (b)(12), the term educational benefits refers solely to benefits provided to a service provider, consisting solely of educational assistance for the education of the service provider, as defined in section 127(c) and the accompanying regulations, and does not refer to any benefits provided for the education of any other person, including any spouse, child, or other family member of the service provider.

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