based on the facts and circumstances, it is part of a plan a principal purpose of which is to avoid or increase the Code Sec. 382 limitation. Notice 2008-78 goes on to list a couple of safe harbors from even having to undergo the facts and circumstances gauntlet.

**Conclusion**

It is way too soon to say just how radically the financial crisis will reshape Wall Street, Main Street or the considerably financial topography in between. That makes it also way to soon to assess how big an impact these various get-out-of-NOL-jail-free cards will have. Even so, as Senator Grassley grumblingly remarked about Congress’ writing of Code Sec. 382 and the IRS’s big relief by notice efforts, these are huge and decisive changes. Secretary Paulson has now said Treasury officials believed the treatment of built-in losses was discouraging bank mergers, which represented worthwhile activity. He has also defended the administrative process producing Notice 2008-83 as “quite legal.” [TAX NOTES, Nov. 17, 2008, at 797.]

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**Fear & Loathing in Code Sec. 409A**

By Robert W. Wood • Wood & Porter • San Francisco

As we enter the post-election and current economic malaise, M&A TAX REPORT readers are no doubt braced for a new raft of tax bills. These tax bills, like those of the recent past, are apt to have vainglorious names. Although I recognize that sometimes something is what you call it, I still wish we could have tax acts that were titled like tax acts. What is wrong with calling something the “Tax Reform Act of [BLANK]?”

In 2004, the nom de plume was the American Jobs Creation Act of 2004, which, by the way, despite its feel good name, included within it a number of tax increases. One increase came in the form of heightened scrutiny (and just plain disallowance) to a number of relatively tried and true deferred compensation arrangements. Think 409A.

With the enactment of new Code Sec. 409A, a cynic might say that the Internal Revenue Code has become such a behemoth that we must now resort to letters as well as numbers. Of course, a cynic might also say that Code Sec. 409A helped the law that enacted it live up to the name hype of the Jobs Act. If nothing else, the Jobs Act certainly led to job creation in executive compensation consultants, tax lawyers and accountants in that field.

**Big Job**

At its root, Code Sec. 409A provides that amounts deferred under a nonqualified deferred compensation plan must be currently included in gross income if they are not subject to a substantial risk of forfeiture, and have not previously been included in gross income. That sounds harsh. Yet, there is a large “but” that allows you to meet certain requirements to fall outside this harsh rule, and back into what one would think of as traditional (pre–Jobs Act) deferred compensation rules.

The current lingua franca holds that a nonqualified deferred compensation plan includes virtually any agreement, method, program or other arrangement that provides for deferral of compensation, where the compensation is not paid until a later tax year. One of the initial stumbling blocks about the scope of this provision is just what constitutes a “plan.”

The following types of arrangements and agreements are among the many types of arrangements that are covered by the broad (and some might say grasping) reach of Code Sec. 409A:

- Any employment, bonus or compensation agreement (even if it covers only one employee!) that results in the deferral of the taxation of compensation
- Supplemental executive retirement plans (sometimes called SERPs), and other nonqualified retirement arrangements
- Restricted stock, phantom stock and performance share plans
- Code Sec. 457f plans
- Certain stock appreciation rights
- Many long-term or multi-year bonus or commission programs

One might assume from the expansiveness of this list that caution is appropriate. Talk about understatement. In fact, the expansiveness may
cause you to want to assume that virtually any kind of deferred compensation arrangement will be within the scope of Code Sec. 409A. Change in control agreements, severance agreements, employment agreements, agreements covering the delayed payout of option proceeds, etc., can all be brought within the reach of this provision.

**Acquisition Jitters**

If you have not considered some of these issues before, you are likely to consider them when you ask a potential target company to produce copies of all nonqualified deferred compensation plans and agreements. On a very fundamental level, if you are a buyer, for tax as well as nontax reasons, you want to know about everything. If you are a seller, you have a schizophrenic reaction.

Although in some respects you may want to disclose everything, you also want to respond only to what’s being requested, and not to complicate things more than they need to be complicated.

In this context, many a target company is likely to think that a contract or “plan” that benefits only one executive or perhaps only a few high management personnel might be outside the scope of such a boilerplate request. In some cases, target counsel are now becoming more specific, asking for information and documentation regarding all nonqualified deferred compensation plans within the meaning of Code Sec. 409A.

Here, one must separate public companies from private companies, since Code Sec. 409A has even longer teeth when it comes to the operations of publicly held entities. As but one example, there is a six-month delay rule in the case of distributions to certain employees. In general, these include key employees from publicly held corporations. Because of the presence of such rules, one should consider a matrix of queries for public to public company acquisitions, public to private acquisitions, and private to public acquisitions.

**Options**

There has long been confusion about the respects in which stock options are subject to the Code Sec. 409A regime. In general, the following types of stock options are treated as nonqualified deferred compensation under Code Sec. 409A if the stock options have an exercise price that is less than the fair market value of the underlying stock on the date of the grant:

- Options granted and vested before January 1, 2005, if they were materially modified on or after October 3, 2004
- Options granted before January 1, 2005, but that were not fully vested as of January 1, 2005 (provided that Code Sec. 409A will apply only to the unvested portion of the option)
- Options granted on or after January 1, 2005

The big point about options, of course, is that Code Sec. 409A rules are triggered dependent upon whether the option was granted with an exercise price equal to or greater than fair market value. That may mean that it’s relatively easy to plan around the applicability of Code Sec. 409A with stock options. Yet, from a due diligence perspective, it means the buyer is going to have to carefully review the target’s option practices, including resolutions and specific option grants, to verify pricing.

It also means there should be significant scrutiny given to whether there has been a “material modification” of the options. A material modification generally means the material enhancement of a benefit or right existing as of October 3, 2004, or the addition of a new material benefit or right that affects the amount earned and vested before January 1, 2005.

Regardless of what the plans may say, part of the negotiation dynamic in an acquisition can include acceleration of option vesting, and cashing out options on closing. This certainly goes beyond the due diligence function, and has significant traps. For example, if the options were discounted (granted at less than fair market value), and the options are accelerated as to vesting or payment of cash to optionees in connection with the termination of the options, Code Sec. 409A may subject the optionee to taxation.

**Other Equity**

Apart from stock options, other equity granting policies should be reviewed too. As with stock options, the key issue is going to be the extent to which options or equity are granted based on an exercise price that is equal to or greater than fair market value versus a discount. One can stumble into Code Sec. 409A applicability, however, with deferral features on equity issuances.

**Severance and Employment Agreements**

Although it is not exactly a due diligence function, any consideration of severance
agreements or employment agreements for the employees of the target should consider Code Sec. 409A implications. Perhaps the most obvious point here is that any such agreement may be written as an attempt to make a target employee whole, as by offering replacement money or consideration for some kind of deferred compensation benefit that is not going to be available.

This is important, since entitlement or payment of benefits that act as a substitute for (or replacement of) amounts considered to be deferred compensation under a plan can also be viewed as subject to Code Sec. 409A.

In appropriate cases, the right to the new payment or new agreement can be considered an impermissible acceleration of payment of the forfeited deferred compensation.

Scratching the Surface
As this abbreviated discussion should indicate, it only scratches the surface of the potential impact of Code Sec. 409A on acquisitions. The implications of Code Sec. 409A on even the most straightforward of acquisitions can be significant and even Byzantine. The sooner one recognizes such issues in the process, the better.

Goodwill As 1031
By Robert W. Wood • Wood & Porter • San Francisco

In California where I live, Section 1031 of the Internal Revenue Code is practically a religion. Its observers may not drink Kool-Aid or follow Jim Jones, but at times, they seem almost that fervent. Even clients who know nothing at all about tax law know one Code Section: 1031.

Real estate values may be off-kilter at the moment, but throughout most of California’s history, real estate was king. Code Sec. 1031 exchanges were like low-hanging fruit on orange trees that were at one time so plentiful. It is not even cynical to suggest that people frequently do Code Sec. 1031 exchanges because deferring tax is a knee-jerk reaction. There’s typically little thought given to crunching the numbers. In some cases taxpayers might conceivably be better off paying a capital gain tax at a historically low rate, and getting a stepped-up basis. Still, deferral being hard to pass up, they do 1031 deals again and again.

Most Code Sec. 1031 exchanges involve real estate. That is the norm, and it is unlikely to change. Nevertheless, I’ve long noted that Code Sec. 1031 is relatively rarely applied in the business context. Exchanges of business assets do occur, and there is even some history of whole businesses (primarily radio stations) being exchanged under Code Sec. 1031. In large part, though, Code Sec. 1031 is not exactly prominently displayed in the toolkit the average M&A lawyer has at his or her disposal.

Plus, that situation could actually become worse, given several recent letter rulings dealing with exchanges of assets. The big stumbling block one encounters when parties in a business context resort to Code Sec. 1031 is goodwill.

There’s Nobody Like You
Goodwill is simply not like-kind to anything. [See Reg. §1031(a)-2(c)(2).] It is one of those totally unique (not to mention hard to define) assets. That means a taxpayer cannot exchange goodwill or going concern value and defer recognizing gain.

One key question in this area, of course, is just what constitutes goodwill. Assets such as trademarks and subscriber lists are sometimes considered goodwill, expanding the definition materially. M&A Tax Report readers should well remember Newark Morning Ledger, S.Ct, 93-1 USTC ¶50,228, 507 US 546 (1993). In that case, the U.S. Supreme Court held that customer lists were distinct and separate from goodwill. Of course, that case was about Code Sec. 197 and its benefits, not Code Sec. 1031.

Still, having assets treated as other than goodwill for one purpose may well be sufficient for another. At least, that’s what I’d argue. Unfortunately, two IRS rulings suggest the IRS thinks otherwise. In TAM 200602034 [Sept. 29, 2005], the IRS addressed a taxpayer that had trademarks and trade names.

The question was whether it could exchange those trademarks and trade names under Code Sec. 1031. The taxpayer argued that the trademarks and trade names were like-kind property, conforming