M E M O R A N D U M

FROM: Tax Partner

TO: Tax Associate

DATE: Mar. 26, 2009

RE: James Smith

Our new client, James Smith, is an unmarried citizen and resident of the United Kingdom. Mr. Smith was a long-time employee of Diversified, Inc., a publicly traded U.S. corporation. Mr. Smith worked for Diversified for more than two decades and was based in the company's U.K. branch office. Prior to the events described below, Mr. Smith worked exclusively in the company's U.K. branch office and only traveled to the United States occasionally for short, personal vacations and the occasional one- or two-day business trip.

At the end of 2005, Mr. Smith was promoted to a high-level executive position in the company. In that position, Mr. Smith was a salaried employee of the company who had to be available to work seven days per week, whenever necessary. In this position, Mr. Smith was required to travel to the U.S. offices of Diversified for substantial periods of time each year. He spent 120 days working in the United States in 2006, 90 days working in the United States in 2007, and 120 days working in the United States in 2008. He did not travel to the United States during those years other than on those work visits.

At the time of his promotion, Mr. Smith became eligible for a variety of different employee benefits that were afforded only to Diversified's high-level employees. Among other benefits, Mr. Smith became eligible to participate in the company's unfunded nonqualified deferred compensation plan. This plan allows certain employees to elect to defer payment of a portion of their compensation. The deferred compensation is then paid at a later time (along with a notional interest payment), as specified in the terms of the plan. The company sets aside the deferred amounts in a so-called rabbi trust, which conforms to the requirements of Rev. Proc. 92-64 and all of the assets of which are located in the United States. For purposes of your analysis, please assume that the plan complies with the requirements of § 409A,[1] and please further assume that this arrangement effectively defers inclusion of the compensation in Mr. Smith's gross income for U.S. federal income tax purposes until he actually receives the deferred amounts.

In addition, Mr. Smith became eligible to participate in Diversified's nonqualified stock option plan at the time of his promotion. Under this plan, Mr. Smith was eligible to receive options to purchase shares of the publicly traded common stock of Diversified at a price equal to the market price of that stock on the date of grant. However, the options would not vest and become exercisable until Mr. Smith had worked for Diversified for two years following the date of grant. At the time of grant, none of the options was considered to have a readily ascertainable fair market value.

As permitted by the deferred compensation plan, Mr. Smith made an election at the end of 2005 to defer 10% of the $250,000 of total compensation that he was expected to be (and, in fact, was) paid in 2006. At the end of 2006 and the end of 2007, Mr. Smith elected to defer the same

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code"), or to the Treasury Regulations promulgated thereunder.

percentage of his salary expected to be received in the following calendar years. In calendar years 2007 and 2008, Mr. Smith's total compensation was $300,000 and $400,000, respectively.

Mr. Smith retired from Diversified at the end of 2008. Under the terms of the deferred compensation plan, he will receive annual, ratable payments of the deferred amounts (increased by the notional interest amount) over a period of five years, beginning at the end of the first calendar year following the calendar year in which he separated from service (i.e., his payments will begin on December 31, 2009, with subsequent installments paid on December 31 of the following four calendar years). Mr. Smith, who, during this period, does not plan to spend more than one to two weeks in the United States per year on vacation, would like to be advised about the U.S. federal income tax consequences to him of receiving these deferred compensation payments.

In December 2006, Diversified granted Mr. Smith an option to purchase 100 shares of its stock at an exercise price equal to the then-current market price of $10 per share. Under the terms of the company's nonqualified stock option plan, Mr. Smith became eligible to exercise that option in December 2008 when Diversified's stock was trading at $20 per share (down from a high of $50 per share earlier in the year). In January 2009, Mr. Smith exercised the option to purchase those 100 shares of common stock when Diversified stock was trading at $25 per share. Mr. Smith would like to be advised about the U.S. federal income tax consequences to him of exercising that option. He would also like to be advised about the U.S. federal income tax consequences of his eventual disposition of the 100 shares of stock acquired on the exercise of that option.

Please research the questions described above and prepare a memorandum for me that explains your findings. The memorandum should be double-spaced and no longer than five pages. I have promised Mr. Smith an answer to his questions no later than April 8, 2009. Please have your memorandum prepared and on my desk by 2:30 p.m. on that date.

A.C.I.