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Nonqualified Deferred Compensation:

Transition to Final Regulations

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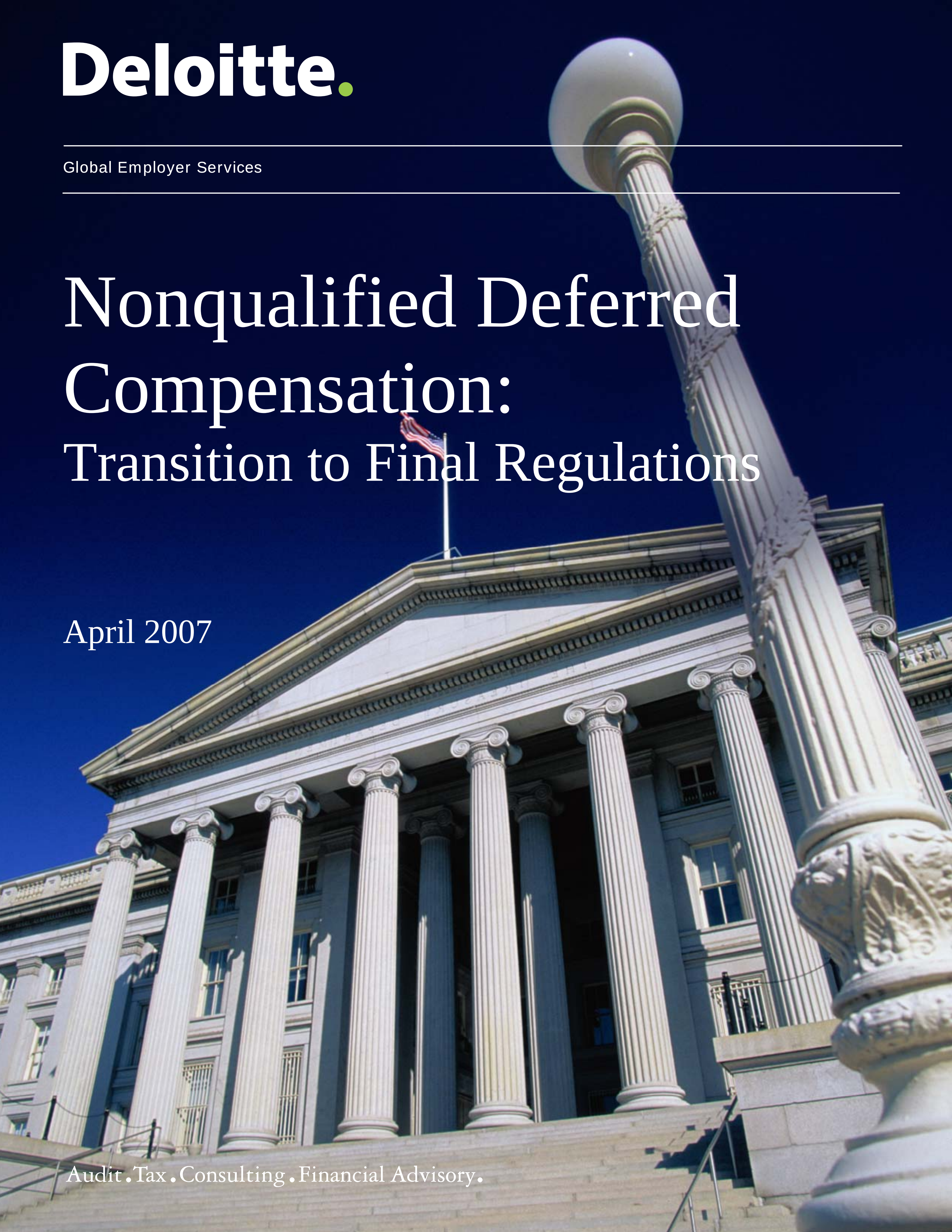

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Introduction

On April 10, 2007, the Internal Revenue Service (IRS) and Treasury Department issued final regulations under section 409A of the Internal Revenue Code of 1986 (the Code). The issuance of these regulations, applicable to periods beginning on or after January 1, 2008, is the latest development in a transition period that began almost three years ago when section 409A was enacted as part of the American Jobs Creation Act of 2004 (AJCA). Section 409A dramatically changes the tax rules applicable to unfunded, nonqualified deferred compensation. While there is more guidance to come, these regulations provide the final rules for many significant issues. Overall, the final regulations include many helpful provisions that will make the rules operate more easily and reduce the risk of inadvertent failure, a positive development given the adverse consequences of a failure to comply. On the other hand, the rules remain lengthy and, as a result, somewhat complicated. Given the scope of the application of the rules, the level of scrutiny and planning associated with deferred compensation arrangements will remain high.

Section 409A was effective beginning January 1, 2005, and applies to deferred compensation that was earned or became vested on or after that date, including amounts earned under agreements entered into after December 31, 2004. In addition, pre-2005 deferred compensation arrangements that are materially modified after October 3, 2004, become subject to section 409A. Because the new law affects existing arrangements as well as new ones and contains significant changes from prior law, there has been an extended transition period to allow taxpayers time to bring affected arrangements into compliance. The transition period is now scheduled to end on December 31, 2007, except for certain plans for certain insiders under section 16(a) of the Securities Exchange Act of 1934 for which it has already ended. Prior to the effective date of the final regulations, taxpayers are required to operate in good-faith compliance with the statute and with Notice 2005-1, issued in late 2004, as well as certain other notices issued after that. Compliance with the proposed or final regulations prior to January 1, 2008, constitutes good-faith compliance, but is not required.

Given the multiple pieces of guidance issued since section 409A was enacted, a key issue facing taxpayers is the end of transition and the shift to a single set of final regulations. The preamble to the final regulations provides significant guidance on how this process will work, and generally allows taxpayers to continue to rely on the good-faith standards for many actions that were taken in the past and would be impossible or difficult to change retroactively. However, there are many aspects of plan operations that must comply with the new rules by the end of this year.

This booklet is an updated version of the one Deloitte Tax LLP released in 2005 discussing the proposed regulations. It describes the provisions of the final regulations, with particular focus on aspects that differ from the proposed regulations. It also addresses the effect of the end of the transition period. Finally, it takes a look ahead at some of the questions that remain unresolved and comments on what we can expect in the future.

Section 409A: Overview

Section 409A provides that amounts deferred by an employee or other service provider under a "nonqualified deferred compensation plan" are included in income when deferred, or, if later, when no longer subject to a substantial risk of forfeiture, unless the plan complies with requirements related to the timing of elections, distributions, and funding. The section applies to both voluntary deferrals and those imposed unilaterally by the employer or other service recipient. The tax treatment of section 409A-compliant deferrals is the same as under prior law. If the service recipient is a for-profit enterprise, participants are taxed on actual or constructive receipt of the amounts that have been deferred. If it is a governmental or tax-exempt organization, taxation occurs as soon as there is no substantial risk of forfeiture, unless the plan meets the conditions of section 457(b) (allowing the deferral of up to $15,500 a year (indexed) without taxation until actual or constructive receipt). If a plan fails to comply with the requirements of section 409A, deferrals are includible in income at vesting and subject to a 20 percent additional tax. Under some circumstances, an underpayment interest penalty will also apply.

Section 409A overlays the existing body of law governing the taxation of nonqualified deferred compensation. Prior law regarding transfers of property in connection with the performance of services (section 83) and constructive receipt (section 451) continues to apply. In addition, the timing and amount of deductions associated with nonqualified deferred compensation, governed by sections 83(h), 162(a)(1), and 404(a)(5), have not been changed by section 409A.

Section 409A is effective for deferrals of compensation after December 31, 2004. Deferrals earned and vested before 2005 remain subject only to prior law unless the plan under which they were deferred is materially modified after October 3, 2004. In that case, they are treated as post-effective date deferrals and are subject to section 409A.

Since the enactment of section 409A, Treasury and the IRS have issued multiple pieces of guidance. The first was Notice 2005-1, which provided initial guidance on the definition of the term "nonqualified deferred compensation plan" for purposes of section 409A, distinguished deferrals that are grandfathered from those subject to the new law, provided transition relief during 2005, and addressed a number of other specific issues, such as the definition of a "change in control." On October 4, 2005, Treasury and the IRS published additional guidance in the form of proposed regulations. The proposed regulations were followed by further guidance:

- Notice 2005-94, addressing reporting and withholding requirements;
- Notice 2006-4, providing guidance on valuation for equity rights and, in particular, allowing taxpayers to rely on the "good-faith" standard under the incentive stock option (ISO) regulations for purposes of determining whether an option or stock appreciation right granted prior to January 1, 2005, was granted with an exercise price not less than fair market value at the date of grant;
- Notice 2006-33, relating to the effective date of the section 409A(b) restrictions on use of offshore trusts and trusts with financial health triggers;
- Notice 2006-79, extending the transition period from December 31, 2006, to December 31, 2007, for most taxpayers under most arrangements;
- Notice 2006-100, providing guidance on reporting and withholding obligations, including obligations with respect to section 409A failures; and
- Announcement 2007-18, offering employers a program pursuant to which employee tax obligations for 2006 under noncompliant plans could be satisfied.

The final regulations follow the same format as the proposed regulations, in particular by adopting a broad general definition of deferred compensation and then providing specific exceptions and rules on compliance. The regulations address many of the comments and concerns raised in connection with the proposed regulations, generally by expanding previous exceptions or including additional guidance to prevent inadvertent failures. The final regulations also include guidance on the requirement that deferred compensation plans be set forth in writing.

Topics that are not addressed in the final regulations include the calculation of amounts included in income in the event of a section 409A failure and the calculation of additional tax based on interest at the underpayment rate plus 1 percent (if applicable); the scope of the funding restrictions under section 409A(b); and the reporting requirements. The IRS and Treasury also have a separate guidance project related to finalizing regulations on compensatory transfers of interests in a partnership. These regulations may also affect the application of section 409A in the partnership context.

Nonqualified Deferred Compensation Plans: What Is Subject to Section 409A?

Definition of "Deferred Compensation"

Section 409A applies to "nonqualified deferred compensation plans." The meaning of this term is therefore critical to understanding the application of the new rules. The statutory definition states only that a nonqualified deferred compensation plan is any arrangement that provides for a deferral of compensation, unless it is otherwise excepted.

Adopting the approach taken in Notice 2005-1 and the proposed regulations, the final regulations include a general definition, with exceptions for short-term deferrals, certain separation pay plans, stock options, stock appreciation rights (SARs), certain foreign plans, tax-favored retirement plans, and many welfare benefit plans.

General Rule

In general, arrangements under which an employee or other service provider[1] receives a legally binding right to compensation in one year but is not in actual or constructive receipt of income until a later year are considered deferred compensation plans for purposes of section 409A. A legally binding right exists to the extent the service provider will have a right to the compensation if the conditions for the compensation are satisfied. Therefore, a service provider can have a legally binding right to compensation before it vests.

Observation
Over the previous months, many taxpayers have used the transition rules to convert plans that would be noncompliant with section 409A to compliant plans or to plans that are excepted from the provisions. The ability to do this ends on December 31, 2007. Beginning in 2008, plans (including, for instance, year-end bonuses earned in 2007) that could result in payment in more than one taxable year could be deferred compensation subject to these rules. Thus, taxpayers will need to take significant care in designing plans to ensure compliance or satisfy the rules for an exception.

No legally binding right exists so long as the service recipient or anyone else has the discretion to reduce or eliminate the compensation unilaterally, unless the facts and circumstances indicate that the discretion lacks substantive significance or is exercisable only upon a condition. The final regulations follow the proposed regulations on this point, and provide that discretion lacks substantive significance, and will not negate the existence of a legally binding right, if it is exercisable by a person whom the service provider controls or by a member of his family.

[1] Section 409A applies to nonqualified deferred compensation arrangements involving common-law employees, independent contractors, and other service providers. See the discussion of the definitions of "service provider" and "service recipient." This booklet uses "service provider" and "service recipient" as generic terms. In most cases, they will be synonymous with "employee" and "employer," respectively.

Observation

One clarification of note is that the final regulations provide that there is a legally binding right "to the extent" that the service provider will have a right to the compensation if conditions are met. The same agreement or plan could provide for an amount to which there is a legally binding right and an additional amount that is purely discretionary. Therefore, the mere existence of discretion to set the amount of compensation does not negate a legally binding right unless it applies to the full amount that can be earned under the agreement.

It is possible for a service provider to have a legally binding right to compensation even if the ultimate amount that he will receive is uncertain because of the manner in which it is calculated. For example, a benefit accrued under a nonqualified plan is legally binding even if it is offset by as yet undeterminable benefits accrued under a qualified plan. Similarly, a bonus plan may result in deferred compensation if the bonus is not calculated until after the end of the year, unless there is no legally binding right because the bonus is discretionary.

Having set forth this broad general rule, the final regulations provide for significant exceptions that delineate the true scope of section 409A, including a few new exceptions not included in the proposed regulations.

Short-Term Deferrals

Under the final regulations, there is no deferral of compensation if the payment is actually or constructively received no later than two-and-a-half months after the end of the year in which the service provider becomes vested in the right to receive it (even if the legally binding right arose in a prior year), and there are no plan provisions that would allow payment to be made at a later date. The "year" for this purpose may be the service provider's or the service recipient's taxable year, whichever ends later. The final regulations also specify that inclusion of income under section 83, the economic benefit doctrine, section 402(b), or section 457(f) constitutes "payment."

The final regulations explicitly provide that whether an arrangement is deferred compensation or a short-term deferral is determined when the legally binding right is created. A plan provides for deferred compensation if it is possible under its terms for payment to occur in either of two taxable years or after the end of the short-term deferral period, even if it is in fact made within that period. Thus, a plan provides for deferred compensation if any part of a payment can be deferred beyond the end of the short-term deferral period. On the other hand, the ability to elect a payment date under an arrangement will not automatically exclude it from meeting the short-term deferral exception, so long as no election or failure to elect can postpone the payment beyond two-and-a-half months after year-end, or allow for the payment in either of two taxable years.

Observation

The final regulations make it possible to apply the short-term deferral exception to the initial payments in a series of explicitly separate payments. The fact that later, separately identified payments will be made beyond the permissible short-term deferral period does not affect the treatment of the earlier payments. The exception is not available, however, for annuities, which are treated under the regulations as a single undifferentiated payment.

The final regulations allow the two-and-a-half month deadline to be extended under some circumstances. First, a payment may retain its status as a short-term deferral if timely payment was administratively impracticable and the impracticability was unforeseeable. Second, a payment may be delayed if making it within the short-term deferral period would jeopardize the ability of the service recipient to continue as a going concern. In either of these cases, payment must be made as soon as the reason for delay ceases to exist. Third, a payment may be delayed if its deduction is restricted by section 162(m) and a reasonable person would not have anticipated that restriction at the time the legally binding right arose. Payment must then be made as soon as the deduction is no longer restricted by the application of section 162(m). The use of this rule could delay payment of a "short-term" deferral for many years, for example, until a newly promoted executive falls out of the group covered by section 162(m).

Observation

The short-term deferral exception is more widely useful than might appear at first glance. It makes section 409A inapplicable to arrangements that require employment through the payment date or under which payment occurs within two-and-a-half months after the end of the year in which the right to the compensation otherwise vests. We expect many service recipients to use this exception to provide for payments contingent on events that would not otherwise be permissible distribution events under section 409A. This can be accomplished by keeping amounts subject to a substantial risk of forfeiture until the event (e.g., an initial public offering (IPO)) occurs.

The final regulations include several key points that affect this exception. First, they underscore that whether a payment fits within the short-term deferral exception is a function of the structure of the agreement, not its operation in fact. Thus, for example, if an individual elected to defer until separation from service compensation that would otherwise be paid in 2008, the short-term deferral exception would not be available if he separated from service in 2008 or early 2009, because the separation *could have* occurred in a later year. A consequence is that, if the service provider is a "specified employee," it will not be possible to use the short-term deferral exception to sidestep the six-month interval mandated by section 409A between that employee's separation from service and his receipt of deferred compensation payable on account of the separation. (As will be discussed later, the final regulations do offer ways to make payments during the six-month window to executives who are involuntarily discharged or who leave for what the regulations define as "good reason.") More significantly, a payment may be delayed if section 162(m) prohibits deducting it, provided that the loss of the deduction was not reasonably foreseeable and the payment is made as soon as it can be expected to be deductible. This delay is permitted without regard to whether it is required under the terms of the agreement pursuant to which the payment is made. As a practical matter, however, it is advisable to include this provision in the agreement so that the service recipient has the ability to enforce the deferral and preserve its deduction.

The regulations also expand the relief for payments that are delayed beyond the two-and-a-half month deadline. They allow delay if the payment would jeopardize the service recipient as a going concern, a somewhat more generous exception than the insolvency requirement of the proposed regulations.

Finally, the regulations are more specific about how to structure a short-term deferral plan so that it will comply with section 409A in the event that payments are delayed beyond the short-term deferral deadline. If a written plan document provides for payments within the short-term deferral period *and* specifies, explicitly or by necessary implication, the calendar year in which the payment must be made, the regulations' rules providing flexibility in the timing of the actual payment are available. Under these rules, a payment that is supposed to be made on a particular date within a calendar year is deemed timely if made by the end of the year. For example, if a bonus plan for 2007 states that payments will be made between January 1, 2008, and March 15, 2008, payment can be made at any time during the 2008 calendar year without violating section 409A. By contrast, a payment under an unwritten plan that missed that deadline (except for one of the reasons discussed above) would automatically be taxable in the year of vesting and subject to section 409A's 20 percent additional tax.

Observation

The use of a written document with a specified payment date will almost always be advisable because of the flexibility it opens up for making distributions. The regulations make clear that a plan that merely provides for payment "before March 15" will not be able to make payments after

March 15 and comply with the rules of section 409A if it was possible for payments to be made before January 1. Therefore, if it is important for the employer to retain the flexibility to make payments before or after March 15, the plan document should be carefully reviewed to ensure that payment cannot span two taxable years and that other potentially applicable section 409A requirements are satisfied.

Stock Options and Stock Appreciation Rights

The final regulations retain the basic structure of the exceptions for certain stock options and SARs (collectively, "stock rights"), but also contain significant expansions, particularly with respect to the stock on which stock rights can be issued and the ability to extend the term of a stock right. In general, nondiscounted stock rights that are issued on service recipient stock and do not have an additional deferral feature are exempt from section 409A. Stock rights that do not meet these criteria may still be granted but will be considered deferred compensation and must comply with all of the applicable section 409A requirements.

There are two main criteria that an exempt stock option must satisfy. First, the exercise price may never be less than the fair market value (disregarding any risks of forfeiture or other lapse restrictions) of the optioned property on the date of grant, and the number of shares subject to the option must be fixed at that time. Second, the option cannot include any feature that defers income inclusion beyond when it would ordinarily occur under section 83 (i.e., exercise or disposition of the option or, if later, substantial vesting in the stock acquired upon exercise). This restriction effectively eliminates the technique of postponing the taxation of option exercise gains through a nonqualified deferred compensation plan.

SARs fall within the stock rights exception by meeting similar, but slightly modified, requirements. First, compensation payable under the SAR cannot be greater than the excess of the fair market value of the stock (disregarding any lapse restrictions) on the date of exercise over the fair market value on the date of grant of a fixed number of shares specified at that time. Second, the SAR may not include any feature that delays income inclusion beyond the exercise of the SAR.

Statutory stock rights, including incentive stock options (section 422) and options granted under employee stock purchase plans (section 423), are excluded regardless of whether they meet the preceding conditions. For example, a discounted option granted under an employee stock purchase plan is exempt from section 409A even though, if not subject to section 423, it would be considered deferred compensation subject to section 409A.

Observation

The stock right exception has evolved significantly since it was first introduced in Notice 2005-1. For example, the exception originally applied to SARs only if they were based on appreciation on public company stock and were settled in stock. The proposed regulations eliminated the difference in treatment between cash- and stock-settled SARs and between private and public company stock, but narrowed the definition of service recipient stock. As discussed below, the final regulations allow stock rights on a broader range of stock and loosen the restrictions on entities whose shares are regarded as "service recipient stock."

Eligible Issuers of Service Recipient Stock. The final regulations modify the rules on what entities can be the issuers of service recipient stock. Stock rights may be granted on the stock of the direct service recipient, or of any corporation that owns a controlling interest in the service recipient or is included in a chain of organizations, each of which is controlled by another organization, ending with the parent organization. The term "controlling interest" is defined by reference to the controlled group rules applicable to qualified plans (Treasury Reg. section 1.414(c)-2(b)(i)) but with "at least 50 percent" substituted for "at least 80 percent." Note that stock of a service recipient's subsidiary or of a brother-sister corporation can never be "service recipient stock" under this definition.

Where there are legitimate business criteria, based on facts and circumstances, for a service recipient to grant an option to a particular service provider, the controlling interest ownership threshold is reduced to 20 percent. Unlike the proposed regulations, the final regulations do not require a formal election to take advantage of the lower threshold. Instead, it may be utilized on a grant-by-grant basis so long as the "legitimate business criteria" in fact exist. The analysis focuses primarily on whether there is sufficient nexus between a particular service provider and option issuer to give the grant legitimate nontax business purposes. The preamble and the text of the final regulations provide several examples of situations in which the lower threshold may be appropriate. For example, a corporate partner in a joint venture ordinarily would have a nontax business reason to grant a stock right to an employee who is reasonably expected to become an employee of the corporation in the future. On the other hand, a corporation that is merely a passive investor in an entity is unlikely to have legitimate nontax business reasons to grant stock options to that entity's employees.

A corporation whose primary purpose is to serve as an investment vehicle can grant stock rights only to its own direct service providers. Furthermore, a general anti-abuse rule has been added as an overlay: any ownership structure or transaction undertaken solely to provide deferred compensation not subject to section 409A will be disregarded in identifying service recipient stock. The final regulations specifically provide that if the primary source of revenue is the provision of management services to other members of the group, the structure will be presumed to be for the avoidance of section 409A.

Observation
Although the definition of "service recipient stock" has been expanded, there are still limitations. It will be important to carefully review arrangements involving subsidiary, management company, and investment vehicle stock.

Eligible Classes of Stock. The proposed regulations would have imposed significant restrictions on the classes of stock with respect to which exempt stock rights could be granted. In particular, they would have limited "service recipient stock" to publicly traded common stock or, if the controlled group has no publicly traded stock, the class of common stock with the highest aggregate value. The final regulations have relaxed this definition by eliminating the distinction between public and private companies and allowing the use of any class of common stock (within the meaning of section 305 and the regulations thereunder) of any eligible service recipient (as discussed above).

Eligible common stock does not include stock with any dividend preference (though a liquidation preference is permitted) or stock subject to either a mandatory repurchase obligation (other than a right of first refusal) or a put or call right at a price other than the fair market value of the stock (though lapse restrictions as defined in Treasury Reg. section 1.83-3(i) are allowed).

American depositary receipts and American depositary shares are treated as service recipient stock if the stock to which they relate would otherwise qualify. Mutual companies (e.g., mutual insurance companies and mutual banks) can issue equity rights to employees using mutual company units. The IRS has reserved the right to issue future guidance under which interests in other types of entities may be treated as service recipient stock. For noncorporate entities, such as partnerships and LLCs, the preamble states that the rules for stock may be applied by analogy.

Observation
The changes to the permissible classes of stock and the permissible issuers of stock rights that may fit the stock right exception respond to comments that the restrictions in the proposed

regulations were too narrow.

Allowing employers to issue rights on the stock of the direct service recipient or any entity up the ownership chain (although not down the chain), without regard to whether there is a publicly traded class of stock in the group, restores the ability to tailor grants to fit specific business objectives. Equally significant, the elimination of the written election and consistency requirements from the proposed regulations allows employers to make grants on a case-by-case basis without concern that grants to employees at one entity could adversely affect the status of grants elsewhere.

The general anti-abuse provision in this section is not the only such cautionary provision added in the final regulations, and service recipients must operate with these general requirements in mind.

Observation

The preamble also includes favorable transition relief that allows grants made prior to April 10, 2007, on stock that met the definition of service recipient stock, based on a good-faith reasonable interpretation of the statute and the applicable guidance, to remain outstanding and not subject to the rules of section 409A as a result of the use of the stock. Because Notice 2005-1 did not include the limitations on permissible classes of service recipient stock first included in the proposed regulations, this relief allows employers that issued grants on preferred stock or strips of common and preferred to leave those grants outstanding without exposing the option holder to liability under section 409A as a result of the use of this equity. A plan that currently provides for grants of stock rights on stock that does not conform to the final regulations may not issue grants on nonconforming stock after April 10, 2007, and avoid the requirements of section 409A. Transition relief is discussed below.

Valuation. One of the requirements for section 409A-exempt stock rights is that the exercise price of stock options cannot be less than fair market value on the date of grant and SARs may not have any built-in gain when granted. As a result, it is important to determine fair market value accurately. For stock that is readily tradable on an established securities market, the final regulations allow the use of any reasonable, consistently applied method for deriving fair market value from actual transactions, including the last sale price before grant, first sale price after grant, or closing price on the trading day before or after grant, as well as an average price over a period of up to 30 days before or after grant if specified in advance. To make use of averaging, the service recipient must designate the recipient of the stock right, the number and class of shares subject to the stock right, and the method for determining the exercise price, including the period over which the price will be averaged, before the averaging period begins.

Observation

The final regulations revised the language of the proposed regulations to make it clear that an average can be used only if the terms of the grant and the averaging period are set in advance of the stated grant date. This change is intended to limit the ability of an employer to use hindsight in setting the exercise price. The regulations include an exception for grants subject to applicable foreign law that requires stock rights be priced based upon a specific averaging method and period. Any stock right granted in accordance with such a law satisfies the valuation requirements of section 409A unless the averaging period is longer than 30 days. The preamble to the final regulations identifies France as a jurisdiction that mandates an averaging method that is permissible even though it would not otherwise qualify. French law requires this result for purposes of favorable tax treatment, and other jurisdictions with similar provisions would be covered by this exception. General practice that is not related to compliance with applicable law would not be.

Determining fair market value is more challenging for stock that is not traded on an established market. In general, the regulations require reasonable application of a reasonable method, taking into account all relevant facts and circumstances, and factors such as the value of tangible and intangible assets, the present value of anticipated cash flows, and recent arm's-length transactions involving the sale or transfer of the stock, to list a few. It is not reasonable to rely on a valuation that is more than 12 months old or that has been rendered obsolete by material changes of fact. If the stock becomes readily tradable on an established securities market after the stock right is granted, the stock must thereafter be valued using the methods for readily tradable stock.

The final regulations retain the three valuation safe harbors introduced in the proposed regulations, with some modifications. Use of one of these methods on a consistent basis is presumed reasonable; to rebut the presumption, the IRS must show that the valuation method or the application of the method was grossly unreasonable. The three safe harbor methods are:

- An independent appraisal that meets the requirements for valuing stock held by employee stock ownership plans and was issued no more than 12 months before the date of grant of the stock right;

- A formula-based valuation that would constitute a nonlapse restriction for purposes of section 83 and will by its terms be used so long as the stock is not publicly traded, provided that it is used both for compensatory transactions and in connection with transfers to the issuer or a 10 percent shareholder, though its use need not be required in a sale of all or substantially all of the outstanding stock; or

- For illiquid stock of start-up companies (generally, those that have been in business for less than 10 years, have no publicly traded class of securities, and do not reasonably anticipate a change in control within 90 days or a public offering within the next 180 days), a reasonable, good-faith valuation evidenced by a written report issued by someone who is qualified, but not necessarily independent.

Consistency in use of a method is a factor in determining its reasonableness and is a requirement for the formula-based method. An employer may, however, use different methods at different times or for different purposes, such as, for example, an average for setting exercise price, but the last trading price prior to exercise for measuring income.

Observation

What is required for valuation is a topic that generated a great deal of comment and question. The final regulations provide some more structure, but the standard still requires service recipients to exercise diligence in setting the exercise price of a stock right.

In particular, the final regulations do not adopt the relief provided under the ISO regulations, which impose no sanctions for a below-market exercise price that was the result of a good-faith attempt to value the stock correctly. The 409A standard is on its face more stringent. Nonetheless, whether a service recipient reasonably applied a reasonable valuation method depends on the facts and circumstances at the time of grant, not on hindsight. The difference therefore seems to be that the IRS will not accept a method that is not in fact reasonable or that is applied in a way that is not reasonable, even if the taxpayer in good faith thought otherwise. Therefore, it is critical that the company select a reasonable valuation method and that this method be applied reasonably, taking into account all relevant facts and circumstances. If this process is followed, it is unlikely that the IRS will challenge the exercise price. Note that the ISO approach is specifically applicable for grants made prior to January 1, 2005, pursuant to Notice 2006-4, and that the rules of Notice 2005-1 and Notice 2006-4, as well as guidance in the proposed regulations, apply for grants made in 2005, 2006, and 2007.

The final regulations confirm that the use of an independent appraiser is not necessary for an acceptable private company valuation under either the general rule or the special rule for start-up companies. However, in both cases, the person performing the valuation must have sufficient knowledge, experience, training, or education to be qualified to do the appraisal. The regulations indicate that five years of relevant experience is generally considered significant experience, but that is not a mandatory credential. The test is whether it would be reasonable to make an investment decision in reliance on the advice this person gives. In many cases, private companies will still want to obtain an independent valuation to gain the benefit of shifting the burden of proof to the IRS, but the confirmation that doing so is not required is helpful.

Effect of Modifications. Like prior guidance, the final regulations provide that a modification of a stock right that gives the holder additional rights is treated as the grant of a new right and must satisfy all of the conditions for section 409A exemption as of the date of modification. The final regulations also include exceptions for modifications in connection with corporate transactions. The most significant expansion in this area is with respect to extensions of the stock right's expiration date.

Under the final regulations, a modification of a stock right, except for an extension or renewal, is treated as a new grant, which is exempt from section 409A only if, at that moment, it meets the conditions for exemption (e.g., the current fair market value of the stock is at or below the exercise price). Any change in the terms of a stock right or plan 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" is a modification. Changes related to the timing of exercisability within the original term, the method of exercise (such as adding the right to tender previously owned shares), or tax withholding are not modifications for this purpose. A renewal or extension, unless it meets the criteria described below, is treated as the addition of a feature allowing for additional deferral, retroactive to the original date of grant. As a result, the renewed or extended stock right is treated as having violated section 409A since its date of inception.

The final regulations allow the term of a stock right to be extended in several instances. First, extensions are allowed if the extended period ends no later than the earlier of 10 years from the date of grant or the end of the maximum term for which the right could have been exercised under the terms of the plan. Second, the extension of an underwater stock right is permissible without restrictions. Finally, if a stock right cannot be exercised without violation of applicable federal, state, local, and foreign laws, or if its exercise would jeopardize the service recipient's ability to continue as a going concern, its term can be extended until no more than 30 days after the date on which exercise is possible without adverse consequences. If an extension does not fall within one of these exceptions, then it will result in the stock grant having an additional deferral feature, and it will be treated as a noncompliant option from the date of original grant.

Observation

The final regulations address two areas of concern. First, by allowing free extension of underwater options, they eliminate an anomaly in the proposed regulations under which it would have been permissible to grant an at-the-money option, but not to extend an option when it is out of the money. Second, the ability to extend the terms of a stock right accommodates situations in which stock rights would, by their terms, expire on separation from service but the employer wishes to provide a longer post-separation exercise period. The provision can be applied in other circumstances as well. It is a significant expansion relative to the proposed regulations, which allowed extensions only until the end of the year of expiration or, if later, the fifteenth day of the third month following the month in which the stock right would otherwise expire.

The final regulations are also more liberal with respect to extensions to allow exercises to comply with applicable law. The proposed regulations specifically referenced securities law, but the final regulations allow extension with respect to any applicable federal, state, local, or, with respect to certain foreign income, foreign law.

At the same time, the preamble makes it clear that the extension provisions are not intended to allow additional deferral features. The key distinction between the two is whether the extension changes the way the amount of income is determined. If the extension provides only for additional time for the individual to select the exercise date, and therefore the date as of which the fair market value of the stock on exercise will be determined, it is not an additional deferral feature (so long as it does not violate the time limits). But if the extension enables the holder to delay income inclusion after exercise, then the extension is an additional deferral feature that will cause the option to violate section 409A as of the date on which the stock right vests.

Substitutions and assumptions of stock rights following a corporate transaction are not treated as modifications under conditions generally similar to those that apply to incentive stock options. The principal constraint is that the aggregate spread between current fair market value and exercise price may not be increased. Unlike the rule for ISOs, it is permissible to change the ratio of the exercise price to current fair market value and substitute a stock right that is relatively more discounted than the original right, although there is no comparable ability to substitute a stock right that is relatively *less* discounted than the original one. Stock rights may also be proportionately adjusted to reflect a stock split or stock dividend. The final regulations allow flexibility in making adjustments in connection with a spin-off or similar transaction. In particular, they allow the substitution of stock rights on stock of both the distributing entity and the distributed entity, without regard to the fact that the recipient is unlikely to be a service provider with respect to both. (Both of the substituted classes of stock must satisfy all of the other requirements for service recipient stock, other than a nexus between the issuer and the service provider.)

Observation

The final regulations explicitly incorporate the definition of "corporate transaction" under the ISO rules. This definition provides that a corporate transaction includes "a corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation; [and] a distribution (excluding an ordinary dividend or a stock split or stock dividend . . ., or a change in the terms or number of outstanding shares of such corporation." Stock splits and stock dividends are covered by a specific rule that allows appropriate adjustments without the application of the modified ratio and spread test.

A substitution following a cash distribution is permitted if the distribution is not an "ordinary dividend." If it is, payment to the holder of the stock right must comply with section 409A. Dividends may be paid currently or accumulated in an arrangement that satisfies either short-term deferral or the ordinary rules of section 409A. Paying accumulated dividends when a stock right is exercised is not allowed. It is treated as reducing the exercise price, which will cause the stock right to fall out of compliance with section 409A.

A distribution that is not an ordinary dividend can be handled in the same way as an ordinary dividend, or the stock rights may be adjusted to reflect the effect on the fair market value of the stock. Whether a payment is an ordinary dividend is a question of general corporate tax law.

The final regulations allow an improper modification to a stock right to be disregarded if it is rescinded by the earlier of the date the stock right is exercised or the end of the calendar year in which the change was made.

Additional Deferral Features. A stock right is subject to section 409A if it includes any additional feature for the deferral of compensation after income recognition has been triggered by exercise. The final regulations clarify that this restriction does not rule out several common features: the stock received on exercise can be nonvested (so that there is no taxation until it vests); the exercise price may be paid by the use of stock that the option holder already owns; plans may include provisions for cashless exercise; and tandem stock options/SARs plans, under which the exercise of either right cancels the other, are permitted.

Defined Terms. The final regulations introduce several definitions of terms necessary to determine whether the stock right exception is satisfied. The definitions of "stock," "date of grant," "exercise price," "exercise," and "transfer" are similar to those in the ISO regulations. Thus, for example, the term "date of grant" is defined as the date on which the granting corporation completes the corporate action necessary to create a legally binding right to the stock right. This action is not considered complete until the maximum number of shares, the exercise price, the class of stock, and the identity of the recipient are designated.

Observation
The defined terms incorporate a number of definitions from the ISO regulations and, presumably, will be applied in a similar fashion. For instance, the definition of date of grant has become increasingly important. As reviews of option procedures have revealed, determining the "date of grant" in practice is not as simple as it might seem. Nevertheless, it is useful to have the same standard for ISO and section 409A purposes. The final regulations also incorporate the ISO rule that communication with the service provider is not required before the grant date. However, an "unreasonable delay" between the corporate action and the notification may be evidence that the corporation did not irrevocably intend to make the grant until notice was provided. As under the ISO regulations, "unreasonable delay" is not a defined term, but, in general, the standard seems intended to address cases in which, despite a stated grant date, there are indications that the service recipient was not in fact committed to making the grant; delaying notification can be a way to reserve the ability to revoke it. Note that the definition of "readily tradable" (regularly quoted by brokers or dealers making a market in such stock) is borrowed from the regulations under section 280G, as the concept is not pertinent to ISO grants. Similarly, the definition of "established securities market," for purposes of section 409A generally, is defined by reference to Treasury Reg. section 1.897-1(m). In Revenue Ruling 2004-87, the IRS interpreted these terms in the context of section 280G and concluded that, when the stock issuer is in bankruptcy, trading may be impaired to such an extent that the stock is not "readily tradable," even if some transactions take place on a few markets. While this rule would not specifically apply here, taxpayers could reasonably apply it by analogy.

Restricted Property

A transfer of property in connection with the performance of services, taxable under section 83, does not result in deferred compensation, regardless of whether the property is subject to a substantial risk of forfeiture. Similarly, benefits under funded, nonqualified plans of deferred compensation taxed under section 402(b) or as section 403(c) annuities are not within the scope of section 409A. Transfers of property must be distinguished from promises to transfer property in the future. A promise to transfer property is outside the scope of section 83 until the transfer occurs, and therefore is treated in the same manner as a promise to transfer cash in the future.

Separation Pay Plans

Another significant exception to the definition of section 409A deferred compensation covers separation pay plans that meet fairly stringent criteria. The final regulations clarify that separation pay is compensation conditioned on separation from service (including separation on account of death or disability), not amounts that could be paid without any separation (including on change in control, unforeseeable emergency, or on a date certain). There are four basic types of 409A-exempt separation pay plans: (1) collectively bargained plans; (2) plans that provide for separation pay on an involuntary separation from service or voluntary separation as part of a window program; (3) certain foreign plans; and (4) plans that provide for certain reimbursements or in-kind benefits in connection with a voluntary or involuntary separation from service. There is also a catch-all exception for any other amounts provided only on separation from service that do not exceed the limit under section 402(g) for the year ($15,500 in 2007).

Observation

Again, the final regulations make clear that the separation pay exception does not apply to amounts that are a substitute or replacement for deferred compensation to which the individual is entitled. The determination of whether a payment is a substitute for deferred compensation is based on the facts and circumstances. Amounts paid by reason of an otherwise voluntary termination are assumed not to be separation pay. This presumption can be rebutted.

Collectively Bargained Separation Pay Plans. This exception covers benefits payable on involuntary separation from service or pursuant to a window program, to the extent that the plan applies to employees covered by a bona fide collective bargaining agreement. The limitations on the time and amount of payment discussed below for nonbargained programs do not apply.

Payments on Involuntary Separation or Pursuant to a Window Program. A separation pay plan is not subject to section 409A to the extent that it provides for payments on an involuntary separation from service or pursuant to a window program and the arrangement meets the following conditions:

- The payments do not exceed twice the lesser of (1) the service provider's annualized rate of compensation for the preceding taxable year (adjusted for certain increases that would have been received in the normal course of employment) or (2) the section 401(a)(17) compensation limit for qualified plan purposes as in effect for the year in which the separation from service occurs. For 2007, the compensation limit is $225,000, so the highest possible separation payment commencing in 2007 is $450,000.
- The payments are made no later than the end of the second calendar year after the year in which the employee separates from service.

A "window program" is defined as one under which employees are given incentives to leave voluntarily during a limited time period.

To qualify for this exception, the amounts involved cannot be available under any other circumstances. Therefore, section 409A-exempt separation pay must be in addition to other deferred compensation. However, even if involuntary termination pay exceeds the amount permitted for this exception, an amount equal to the limit can be excepted from the section 409A rules.

Observation

The most significant change to this exception is clarification of its relationship to deferred compensation under other section 409A-covered arrangements. This is particularly important for "specified employees," whom section 409A subjects to a six-month delay on distributions in connection with a separation from service. Using the separation pay exception, an employer is able to adopt a "true" severance pay program and make earlier payments to specified employees who leave involuntarily.

An alternative, and generally more flexible, way to work around the six-month rule is to make use of short-term deferrals. The final regulations confirm that separation pay that is available only upon involuntary termination or resignation for "good reason" is subject to a substantial risk of forfeiture, vesting only when the specified event occurs. There is no limit on the amount of short-term deferrals, only the requirement that they be paid no later than two-and-a-half months after the end of the year of vesting.

Why might an employer choose one approach over the other? The one advantage of the separation pay exception is that it allows payments to continue for the full six-month period immediately after separation, or longer, whereas the payment of short-term deferrals may have to be truncated to satisfy the two-and-a-half month rule.

Also of great significance are the expansion of the definition of "involuntary separation from service" to include certain voluntary terminations for "good reason" and the ability to provide for certain reimbursement or in-kind benefit arrangements in addition to involuntary separation pay or short-term deferral payments. These arrangements are discussed below.

Reimbursement and In-Kind Benefit Plans. The final regulations expand this exception to cover any reimbursement includible in gross income provided on voluntary or involuntary separation from service, including, but not limited to, reimbursement for expenses that would otherwise be deductible by the service provider under section 162 or 167 (without regard to the limitations based on adjusted gross income), reasonable moving or outplacement expenses, and medical expenses. Reimbursements for moving expenses can include reimbursement of the loss incurred on the sale of a primary residence in connection with a separation from service.

If, instead of reimbursement, the employer provides benefits in kind, they are exempt from section 409A to the extent that an analogous right to reimbursement would be exempted. In-kind benefits include office space and use of company cars or aircraft.

Generally, expenses must be incurred, or in-kind benefits must be provided, by the end of the second year following the year in which separation from service occurs, and all reimbursements must be paid by the end of the third year. For medical expenses, however, the reimbursement can continue through the applicable COBRA continuation period. The exemption is not negated if the plan extends the right to reimbursements or in-kind benefits beyond the permitted period, though later payments must comply with the section 409A rules.

Observation

The guidance on reimbursements and in-kind benefits provides significantly more flexibility to continue these arrangements following separation from service than would have been provided under the proposed regulations. As a result, employers can make benefits available following a separation from service, without regard to the six-month delay for distributions to specified employees.

Indemnifications, Liability Insurance, Legal Settlements

New exceptions in the final regulations exclude indemnifications, liability insurance, and legal settlements from the definition of nonqualified deferred compensation. With respect to legal settlements, however, the regulations include a tracing rule to prevent settlements from altering the timing of compensation that would otherwise be subject to section 409A.

Observation

Service providers who settle litigation with service recipients will often want to receive immediate payment of all amounts due. To the extent that the settlement includes deferred compensation liabilities, section 409A forbids acceleration of payment except under very limited circumstances.

Educational Benefits

A final new exception covers the provision of educational benefits — including tuition and books for educational courses other than education involving sports, games, or hobbies — to the service provider (but not to anyone else).

Qualified Plans and Other Tax-Favored Retirement Vehicles

Section 409A does not apply to qualified pension, profit-sharing, and stock bonus plans (sections 401(a) and 403(a)), tax-sheltered annuities and custodial accounts (section 403(b)), simplified employee pensions (section 408(k)), SIMPLE retirement accounts (section 408(p)), eligible deferred compensation plans (section 457(b)) or qualified governmental excess benefit arrangements (section 415(m)). The final regulations also exclude plans covered by section 402(d) (certain plans with a foreign-situs trust) and certain Puerto Rican plans, as described in section 1022(i)(2) of the Employee Retirement Income Security Act of 1974, as amended.

Welfare Benefit Plans

Welfare benefit plans, including bona fide medical, vacation, sick leave, compensatory time off, disability, and death benefit plans are exempt from section 409A even though some of the benefits under these plans, such as retiree medical benefits, may be payable in the future. Taxable medical benefits, such as certain medical expense reimbursements for highly compensated employees under a self-insured employer plan, are not excepted from section 409A.

Observation
The regulations do not provide further guidance on what constitutes a bona fide sick leave or vacation plan. Taxpayers may interpret these terms by reference to the guidance under section 457. Death and disability benefits are defined by reference to the Federal Insurance Contributions Act (FICA) regulations under section 3121(v)(2). In general, death and disability benefits must be payable only upon the specified event. The payment of deferred compensation as a death benefit to a service provider’s beneficiary is not an exempt welfare plan. Note that discriminatory medical expenses not excepted by this rule may be excepted as separation pay as discussed above.

Foreign Plans

There are several exemptions aimed at limiting the effect of section 409A on nonresident aliens and on U.S. citizens or residents who participate in non-U.S. plans. The regulations confirm that section 409A does not apply to deferred compensation contributions or accruals to the extent they are exempt from U.S. taxation under an applicable tax treaty. As noted above, a plan that results in income under section 402(b) does not provide for deferred compensation.

In addition, the regulations limit the reach of section 409A as follows:

- Deferred compensation that is not U.S.-source income and that was earned and vested while the service provider was a nonresident alien is exempt from section 409A, including future earnings to the extent the earnings are not excessive. This exemption is important for an individual who later becomes a U.S. taxpayer (by taking a job in the U.S. after accruing deferred compensation abroad, for example).

- Deferred compensation also does not include deferrals by a U.S. citizen or resident alien that would have constituted “foreign earned income” (under section 911(b)(1), without regard to section 911(b)(1)(B)(iv)) if paid directly, except to the extent that, when combined with current compensation, it exceeds the foreign earned income exclusion (currently $80,000 per year).

- The same principle applies to deferred compensation that, if directly paid, would be exempt under the exclusions applicable to bona fide residents of Guam, American Samoa, the Northern Mariana

Islands (section 931), and Puerto Rico (section 933), and to foreign employees of foreign governments and international organizations (section 893).

- Where a nonresident alien's deferred compensation is U.S.-source income and not excluded from U.S. taxation by treaty, it is nonetheless exempt from section 409A to the extent that it does not exceed the section 402(g) limit in effect for the year.

- Benefits under foreign social security systems are excluded from section 409A, whether or not a social security totalization agreement is in effect.

- Tax equalization adjustments (made to offset differences between U.S. and foreign effective tax rates where income is subject to tax in more than one jurisdiction) for U.S. persons working abroad are excluded from section 409A, so long as they are paid by the end of the second taxable year following the year in which the service provider's U.S. tax return is required to be filed for the year to which the compensation subject to the equalization payment relates. If the service provider's foreign tax return or tax payment for the year to which the underlying compensation relates is due later than the U.S. tax return, however, the tax equalization payment can be made as late as the end of the second taxable year after the foreign tax return or payment is due. Finally, payments related to audits or litigation are excepted if paid by the end of the year following the year incurred.

Observation

There is no exclusion for other expatriate benefits, such as housing subsidies and cost-of-living differentials. However, in most cases these allowances are paid currently and, therefore, often will fit within the short-term deferral exception. The special rule for tax equalization payments is designed to accommodate the delays inherent in calculating taxes and filing returns under multiple tax systems.

The regulations also include exceptions related to benefits under certain broad-based retirement plans. The exception is more limited for U.S. citizens and lawful permanent resident aliens than it is for nonresident aliens, other U.S. residents, and bona fide residents of U.S. possessions (as defined in section 937).

A broad-based retirement plan is a written plan designed to provide retirement benefits that are significant and nondiscriminatory, and that covers a wide range of employees, substantially all of whom are nonresident aliens.

- For U.S. citizens and lawful permanent residents who are not eligible under a U.S. qualified employer plan, nonqualified deferred compensation does not include nonelective benefits under a broad-based retirement plan to the extent that they are based on modified foreign earned income and do not exceed the limits applicable to qualified plans. "Modified foreign earned income" is foreign earned income as defined in section 911(b)(1), but includes amounts received after the close of the taxable year following the taxable year in which the services are performed and is determined without regard to the section 911(b) residency requirements, so that bona fide foreign residence or presence abroad for at least 330 days in a 12-month period is not necessary. The proposed regulations would have limited this exception to plans maintained by a non-U.S. employer; the final regulations did not adopt that limitation.

- For nonresident aliens, certain other residents, and bona fide residents of possessions, there is a general exemption for benefits accrued under a broad-based foreign retirement plan.

In the first year in which an individual becomes a resident alien, the regulations provide an additional period during which any necessary plan amendments or deferral elections can be made. This period extends to the end of the calendar year of the change in status. Any election can relate only to amounts not previously paid or made available. In addition, these special rules are available only to individuals who have been nonresident aliens for the prior three consecutive calendar years.

Deferral Arrangements for Independent Contractors

Independent contractors (other than corporate directors and persons who provide management services) are generally exempt from section 409A if they provide significant services in the same trade or business to two or more parties unrelated to each other (and unrelated to the independent contractor). Whether a party is related for this purpose is determined by reference to sections 267(b) and 707(b)(1), subject to two modifications: (1) the 50 percent control test in those sections is reduced to 20 percent, and (2) an individual's "family" is expanded to include spouses of siblings, ancestors, and lineal descendants. Parties are also considered to be related if they are engaged in trades or businesses under common control (as defined in section 52(a) and (b), which differ slightly from section 1563(a) and sections 414(b) and (c)). The 409A exemption is not available for an independent contractor's deferred compensation from a related party unless the arrangement with the related party is substantially similar to those with unrelated parties.

Whether the services provided to two or more parties are "significant" is a question of "facts and circumstances," but the final regulations include a safe harbor: an independent contractor who is in fact providing services to two or more independent parties is deemed to be providing significant services to two or more so long as none of them accounts for more than 70 percent of total revenue for the taxable year. A provider that has met this test for at least three consecutive years may assume that it will be met in the current year, unless he has reason to know otherwise at the time of a deferral.

As noted above, the exclusion for independent contractors is not available to directors or for providers of "management services," which include "services that involve the actual or de facto direction or control of the financial or operational aspects of a trade or business of the service recipient" and "investment management or advisory services provided to a service recipient whose primary trade or business includes the investment of financial assets (including investments in real estate), such as a hedge fund or a real estate investment trust."

Other Important Definitions

The final regulations carry over a number of other key definitions from the proposed regulations, again with significant revisions.

Service Provider

Section 409A applies only to deferred compensation earned by service providers. As in prior guidance, the term "service provider" is (1) an individual, (2) a personal service corporation (or an entity that would be a personal service corporation if it were a corporation), or (3) a qualified personal service corporation (or an entity that would be a qualified personal service corporation if it were a corporation).[2] As in the proposed regulations, corporations, S corporations, and partnerships can all be "service providers" under these provisions. However, only cash-basis service providers are subject to section 409A.

Observation
The final regulations confirm that cash-basis corporations and partnerships will need to monitor compliance with section 409A. In many cases, the independent contractor exclusion will moot the issue, but it will have to be addressed by entities that work primarily for a single client or for

[2] A personal service corporation (defined under section 269A(b)(1)) is a corporation whose principal activity is the rendering of personal services by employee-owners. A qualified personal service corporation (defined under section 448(d)(2)) is an entity performing services in the fields of health, law, engineering, architecture, accounting, actuarial science, the performing arts, or consulting where substantially all of the stock is held directly or indirectly by the employees performing services for such corporation.

related parties, that provide management services, or that provide investment advisory services to investment funds.

Service Recipient

Like the proposed regulations, the final regulations provide that a "service recipient" includes the entity for which services are performed and all members of its controlled group, applying the definitions of "controlled group" in section 414(b) and (c). The section 414(b) and (c) definitions are generally similar to the "controlled-group" definition in section 1563(a), except that foreign and noncorporate entities are included in a group.

Observation

In addition to this general definition, the regulations also provide specific definitions of service recipient for use in determining whether there is a "separation from service" and under the stock right exception. In both cases, service recipients have the ability to use a lower level of ownership to identify the service recipient.

Plan

The definition of "plan" changed significantly between the proposed and the final regulations, generally in a direction that reduces service providers' exposure in the event of a failure to comply with section 409A. With certain exceptions, a "plan" consists of all deferred compensation arrangements of the same type between a single service provider and a single service recipient, without regard to how many different documents embody these arrangements or how many other service providers they cover.

Observation

The final regulations provide that plans related to service as an employee are not aggregated with plans related to service as an independent contractor. For an employee who also serves as a director, the director plan is not aggregated with an employee plan, assuming the director plan is substantially similar to the arrangements provided to nonemployee directors. However, plans related to service as a director and a consultant by the same service provider to the same entity would be aggregated.

The final regulations retain the division of plans into different types, but include additional categories, taking the number of aggregation groups from four under the proposed regulations to nine under the final regulations. These aggregation groups are:

- Account balance plans that provide for nonelective deferrals, including matching contributions, other than ones that fall into more specific categories outlined below;
- Account balance plans that provide for elective deferrals to the extent that the deferred amounts can be separately identified and are not identified in the more specific categories outlined below;
- Nonaccount balance plans, other than those identified in the more specific categories outlined below;
- Separation pay plans that pay only on an involuntary separation from service (including payments meeting the "good-reason" requirements) or pursuant to a window program, other than in-kind benefit or reimbursement plans;

- In-kind benefit or reimbursement plans, to the extent that the right does not constitute a substantial portion of overall compensation or of amounts received on account of a separation from service;

- Split-dollar life insurance arrangements;

- Foreign plans under which substantially all the participants are nonresident aliens for service providers that do not participate in substantially similar domestic arrangements;

- Stock right arrangements subject to section 409A; and

- All other arrangements not otherwise categorized above.

The definitions of "account balance" and "nonaccount balance" plan are borrowed from the FICA tax regulations under section 3121(v)(2) applicable to deferred compensation. Generally speaking, these types of plans correspond to defined contribution and defined benefit plans, respectively. The final regulations subdivide account balance plans into elective and nonelective plans to the extent the amounts deferred (and earnings thereon) are separately identified. The bifurcation rules of Treasury Reg. section 31.3121(v)(2)-1(c)(1)(iii)(B) are applied to separate account balance and nonaccount balance plans that are part of the same arrangement; they are not treated as a single nonaccount balance plan.

Observation

The definition of "plan" and the aggregation groups are important, because a violation of section 409A results in inclusion in income of all amounts deferred by the participant under the plan with respect to which the violation occurred and all other plans in the aggregation group. The increase in the number of categories under the final regulations is a positive development for taxpayers, as it will tend to reduce the effect of violations. For instance, a violation with respect to the elective deferral portion of an account balance plan of a particular service provider results in immediate taxation of all of that individual's own elective deferrals, but not of any deferred compensation provided under plans in other categories or with respect to other service recipients. Also protected are deferrals by other service providers who participate in plans with the same service recipient.

Written Plan Requirement. A plan must be in writing. A plan is "established" when a service provider has a binding right to deferred compensation. The written document may be adopted subsequently, but no later than two-and-a-half months after the end of the taxable year in which the binding right arose. (The two-and-a-half month extension is not allowed if any distributions are payable in the year immediately after the initial year.) The plan's formal date of establishment is the earlier of (1) the date on which a binding right first arose or (2) the latest of the date of adoption, the stated effective date, or the date on which all material terms are reduced to writing.

The material terms of the plan may be set forth in more than one document. They include the amount (or method or formula for determining the amount) of deferred compensation provided under the plan and the time and form of payment.

A plan that lets participants make deferral elections must specify in writing, before any election becomes irrevocable, the conditions under which an election may be made. A written plan does not have to specify the conditions under which payments may be accelerated, although any acceleration must comply in operation with section 409A.

A written plan that covers a specified employee must include a provision requiring the six-month delay before the specified employee may receive a distribution on account of separation from service. This provision must be included as soon as the service provider becomes a specified employee or on the earliest date on which it might be possible for the service provider to receive a distribution on separation, whichever is later.

The plan aggregation rules are modified to the extent that there is a plan document failure. If the failure is solely due to noncompliance with the written plan requirement, it will affect only deferred compensation provided under the unwritten arrangement. There is no effect on the service provider's other, written plans in the same category.

Savings Clauses. The final regulations specifically state that general provisions of a plan that purport to nullify noncompliant plan terms, or to supply required specific plan terms, are disregarded. Thus, if a plan contains terms that do not meet the requirements of 409A and the regulations, or fails to contain a required plan term, it violates 409A and cannot be saved by general language mandating compliance. Despite this rule, it is likely that practitioners will continue to include savings clauses in their documents, as they are a useful guide for resolving ambiguities.

Observation

The written plan requirements in the proposed regulations were a source of concern to taxpayers, as the failure to include a material term in a document applicable to many participants might subject all of them to taxation under section 409A, even if their plans complied in operation.

The final regulations reduce the number of specific terms that must be included in a written document, thereby lessening the risk of defects in documentation. In addition, some required provisions, such as those relating to distributions to specified employees, do not have to be added until they become applicable, rather than at the time of an initial deferral.

Nonetheless, there are specific documentation requirements that must be met, which will necessitate careful attention to plan drafting. Moreover, it may be essential or prudent to include terms that are not mandatory. For example, short-term deferral plans require no plan document, but, for reasons discussed above, reducing them to writing makes it possible to delay payments beyond two-and-a-half months after the end of the year. Other provisions, such as postponement of distributions in order to avoid the disallowance of deductions under section 162(m), will be difficult to enforce if they are not part of the written plan.

Substantial Risk of Forfeiture

For purposes of section 409A, a substantial risk of forfeiture exists so long as the receipt of deferred compensation is conditioned on the performance of substantial future services or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. A condition must relate to the services provided or to the service recipient's business activities or organizational goals. For example, a promised bonus is subject to a substantial risk of forfeiture if the service provider must continue as an employee for a specified period of years or until a specified event, such as the service recipient's IPO. A substantial risk of forfeiture also exists if no further services are required but the bonus is conditioned on a business-related event, such as an IPO within a limited period of time or at no less than a specified price. Conditions unrelated to the service recipient are not substantial risks of forfeiture, e.g., forfeiture if an employee's child does not enroll in college.

Although this definition parallels that used for purposes of sections 83 (transfers of property in connection with the performance of services) and 457(f) (unfunded deferred compensation plans of tax-exempt organizations), there are some notable differences. First, a requirement to refrain from performance of services (a "noncompete agreement") cannot create a section 409A substantial risk of forfeiture. Second, any extension of a substantial risk of forfeiture after the beginning of the service period is not effective; the risk is considered to end in accordance with the original plan terms. Third, elective deferrals of compensation cannot be subject to a substantial risk of forfeiture unless the amount subject to the risk (other than earnings or amounts that would otherwise be paid for future compensation) is materially greater than the amount that is electively deferred.

Involuntary Separation from Service

The final regulations include a separate definition of "involuntary separation from service." (The general definition of "separation from service" is discussed below in connection with permissible distribution events). Whether a separation is involuntary is important for the separation pay plan exception and for the short-term deferrals that are contingent on an involuntary separation from service. Notably, the regulations address when a termination by the service provider for good reason will be treated as an involuntary separation from service.

In general, an involuntary separation from service results from the unilateral decision of the service recipient to terminate the service arrangement with the service provider when the service provider is otherwise willing and able to continue providing services. Whether a separation from service is involuntary is based on the facts and circumstances. A termination at the request of the service provider is voluntary. On the other hand, a resignation tendered under the threat of dismissal is not voluntary. The regulations further provide that the characterization by the parties is presumed correct, but is not determinative.

The final regulations allow a service recipient to treat certain terminations for good reason as involuntary. The regulations include general provisions and a safe harbor. Generally, a good-reason termination is treated as an involuntary separation from service when the termination is based on the occurrence of bona fide conditions that are functionally equivalent to an involuntary separation. The conditions must require action by the service recipient resulting in a material negative to the service provider, such as duties to be performed, compensation, or the conditions under which duties are performed. Other factors include whether the service provider is required to give notice of the unfavorable conditions and provide the service recipient with a period in which to cure the violation. Another relevant factor is whether the compensation on a good-reason termination is the same as the compensation on an involuntary separation from service. A good-reason termination clause cannot be used as a way to avoid section 409A with respect to amounts that are otherwise deferred compensation payable on a voluntary separation from service.

The safe harbor under the regulations lists several specific conditions that will be treated as a bona fide basis for a good-reason termination. These conditions are:

- A material diminution in base compensation;
- A material diminution in authority, duties, or responsibilities;
- A material diminution in the authority, duties, or responsibilities of the supervisor to whom the service provider reports, including a requirement to report to an officer or other employee, rather than directly to the board of directors (or similar governing body);
- A material diminution in the budget over which the service provider retains authority;
- A material change in the geographic location at which the service provider must perform the services; and
- Any other action or inaction that constitutes a material breach by the service recipient of the agreement under which the service provider provides services.

The safe harbor requires that the termination occur within the two-year period following the initial occurrence of one or more of these conditions. The amount, time, and form of payment on a good-reason termination must be substantially identical to those applicable to an involuntary separation from service, to the extent such a right exists.

Finally, the safe harbor includes specific requirements with respect to notice and cure: the service provider must be required to give notice no more than 90 days after the conditions providing a basis for a good-reason condition first exits, and must allow the service provider no less than 30 days in which to cure the violation.

There is also a provision specific to collectively bargained arrangements that requires separation from service from all service recipients. In this situation, any reasonable definition of involuntary separation from service consistently used that was the subject of arm's-length negotiations is acceptable.

Dividends, Dividend Equivalents and Earnings

It is permissible for a plan to treat earnings separately from initial deferrals. Therefore, rather than distribute earnings at the same time as the deferred amount, a plan may pay them out as short-term deferrals two-and-a-half months after the end of the calendar year in which the earnings accrue, or it may distribute them in accordance with a separate, section 409A-compliant arrangement. The extent to which amounts are considered “earnings” rather than initial deferrals is determined by reference to the earnings rules in the FICA regulations. Thus, for account balance type plans, earnings must reflect the rate of a predetermined actual investment or a reasonable rate of interest, and for nonaccount balance type plans, an increase due solely to the passage of time using reasonable actuarial assumptions and methods. To the extent that amounts are in excess of the amount that can be treated as earnings, they are treated as deferrals, and are subject to the terms of plan applicable to initial deferrals, not earnings.

Dividend equivalents are also covered by this rule, and can be paid currently or under a separate deferred compensation arrangement that provides for short-term deferrals or complies with section 409A. In general, the existence of a separate dividend equivalent right will not affect the exemption of the related stock right. However, a dividend equivalent right cannot provide for payment on exercise of a related stock right, as this distribution schedule does not comply with the short-term deferral rule or section 409A. Furthermore, such a payment schedule is treated as a reduction in purchase price that will result in the loss of the stock right exemption for the underlying stock right.

Application to Partnerships, Exempt Organizations, and Split-Dollar Life Insurance

Partnerships

Nonqualified deferred compensation arrangements between a partnership and its employees are subject to the standard section 409A rules. The final regulations do not provide further guidance on the scope of these requirements. Instead, they reserve this issue and provide that, pending further guidance, grants of profits interests, other partnership interests, and options on partnership interests are subject to the rules governing stock rights. Payments to retiring partners in liquidation of their partnership interests, other than certain payments on account of retirement, are not subject to section 409A. Until further guidance is issued, a retiring partner may establish the time and form of payment of amounts exempt from self-employment taxes under section 1402(a)(10) at any time before the last day of the tax year preceding the tax year in which such payment will be made. For example, if a partner wants to retire from the partnership and begin receiving payments at age 58 in a form that will be exempt from employment tax under section 1402(a)(10), he needs to make an election by the end of the year in which he turns 57.

Payments to a partner in other than in a partnership capacity are subject to section 409A if they otherwise constitute nonqualified deferred compensation. In addition, guaranteed payments described in section 707(c) are subject to section 409A if attributable to the performance of services and not included in the partner’s income by the fifteenth day of the third month following the end of the tax year in which he first had a vested, legally binding right to the payment.

Tax-Exempt Employers

As previously discussed, section 403(b) and 457(b) plans sponsored by tax-exempt employers are exempt from section 409A.

Section 409A does, however, apply to deferred compensation described in section 457(f). Under that section, unfunded deferred compensation paid by tax-exempt employers is included in the service provider’s gross income when it is no longer subject to a substantial risk of forfeiture (as defined for purposes of section 457(f) rather than 409A). The final regulations clarify that the inclusion of income under section 457(f) is a payment for purposes of section 409A. The coincidence of vesting and "payment" means that the amount of deferred compensation subject to section 457(f) will ordinarily be exempt from section 409A as a short-term deferral. That exemption is not available for earnings credited after vesting, which section 457(f) does not tax until distribution. It also is not available if the vesting period has been extended or if the substantial risk of forfeiture under the section 457(f) plan is a noncompete agreement. As a result, exempt organizations' plans must comply with section 409A.

Observation
As noted above, the definition of "substantial risk of forfeiture" for purposes of section 409A differs from that used elsewhere. The final regulations state that this definition provides guidance only with respect to section 409A and should not be applied to section 457(f). Thus, pre-existing rules governing the timing of vesting and income inclusion under section 457(f) continue to apply. Plans that are subject to section 457(f) frequently distribute participants' benefits in full shortly after vesting and thus can qualify as section 409A-exempt short-term deferral plans. However, if the plan has a vesting condition that is disregarded for purposes of section 409A, it must comply with section 409A in order to avoid the 20 percent additional tax and, in some cases, the additional interest rate tax.

Split-Dollar Life Insurance Arrangements

Split-dollar life insurance arrangements, including those entered into before, on, or after September 17, 2003, are subject to section 409A if they provide for deferred compensation that is earned and vested after 2004. Thus, arrangements that provide only death benefits and those which have no additional benefits vesting after 2004 are not subject to the rules. For purposes of this rule, increases in cash surrender value are not considered earnings associated with prior deferrals if they relate to policy cash value attributed to services performed, compensation earned, or premiums paid after 2004. Where arrangements have amounts both subject to the 409A rules and those not, any reasonable method may be used to allocate increases in cash surrender value to the two periods, assuming policy costs and expenses are not disproportionately allocated to the portion subject to section 409A.

For arrangements entered into before September 18, 2003, where the value of current life insurance protection is treated as an economic benefit annually pursuant to Notice 2002-8, the amounts will not be subject to section 409A as long as the arrangement is not terminated and the parties continue to report the value of current life insurance protection as income. Arrangements entered into before September 18, 2003, which are treated as loan arrangements pursuant to Notice 2002-8 will not be considered deferred compensation, unless payments are, or are anticipated to be, waived, cancelled, or forgiven. Arrangements entered into before September 18, 2003, that do not take advantage of either of these special rules outlined in Notice 2002-8, will be subject to the 409A rules. Arrangements entered into after September 17, 2003, will also be subject to the 409A rules unless the arrangement is treated as a split-dollar loan or amounts are taxed during the short-term deferral period under the current access or other economic benefit rules that apply to the taxation of split-dollar life insurance arrangements.

Finally, the modification of a split-dollar life insurance arrangement to bring it into compliance with section 409A or to enable it to avoid the application of those rules will not be considered a material modification for applying the effective date rules of the split-dollar regulations. Of course, any amendment cannot enhance the value of benefits under the arrangement.

Observation
It will be important for employers with split-dollar life insurance arrangements to determine what portion of the arrangement — including earnings — was earned and vested after 2004. Employers with split-dollar life insurance arrangements that need to comply with the rules will want to amend them to do so during the remaining transition period. In most cases, employers will want to amend the arrangements to specify a distribution date that complies with section 409A.

Initial Deferral Elections

Section 409A provides specific requirements related to the timing of initial deferral elections. The final regulations provide guidance on the application of these rules, including the special deferral rules included in the proposed regulations, and a few new provisions.

Overview of Election Requirements

The requirements for timing of elections apply not only to the decision to defer compensation, but also to the time and manner in which it will be distributed. An election is not considered made until it becomes irrevocable. A plan may provide that the prior year's election will carry over unless affirmatively changed or revoked.

The regulations also clarify that a service provider election may be required before there is a legally binding right to the payment. For example, with a discretionary bonus, there may be no legally binding right until the bonus is declared. If the service provider can elect whether to defer a portion of this bonus, however, that election must be made based on application of the election rules relative to the service period to which the bonus relates. Elections may include conditions to deal with this uncertainty. For example, a plan could permit an employee to elect to defer a set percentage or the portion in excess of a set dollar amount, or the plan could apply a different formula, as long as it is objective and does not allow for exercise of discretion.

The final regulations also provide that decisions with respect to the timing of payment made by a service recipient (i.e., nonelective plans) must be made no later than the date as of which a service provider has a legally binding right to the payment or, if later, the date as of which a service provider election would be required to be made.

Observation
As noted above, the timing of deferral elections is one of the areas that must be addressed in a written plan document. The regulations include a number of alternatives that may apply to an arrangement. The service recipient must decide which to make available and then incorporate them.

General Rule for Timing of Elections

An election complies with section 409A only if it is made by the end of the year before the calendar year in which the related services are to be performed. Elections with respect to compensation from a service recipient with a fiscal year can be made on that basis, if the compensation is determined on the basis of the fiscal year. This exception does not apply to salary or other compensation that is not earned on the basis of the fiscal year.

Short-Term Deferrals

If an arrangement would otherwise constitute a short-term deferral, then an "initial" deferral election can be made in accordance with the rules for changes in deferral elections using the vesting date as the original payment date. These rules are discussed in more detail later. Their effect is that the time and manner of distribution of a short-term deferral may be changed only if the new election is made at least 12 months prior to vesting and the distribution date is postponed for at least five years.

Forfeitable Rights

A deferral election with respect to compensation subject to a substantial risk of forfeiture can be made up to 30 days after the grant, provided that the participant is required to perform services for at least 12 months after the date of an election. The regulations provide that an arrangement will not fail to require 12 months of continued service merely because the amounts become vested on disability, death, or a change in control. If one of these events occurs, however, the deferral election will be effective only if it complies with the general rules (e.g., the election was actually made prior to the beginning of the year in which the related services are provided).

Observation
The exception for forfeitable rights is sometimes referred to as an exception for ad hoc grants, although the service recipient may make all these elections for grants made at the same time year after year. It is crucial, however, that at least 12 months of services be required after the date on which any election is made. This requirement may mean that at least 13 months of service are required from the grant date. In the event that vesting is accelerated by disability, death, or a change in control during this 12-month period, any election under this rule is voided.

Initial Eligibility

A deferred compensation plan can allow a service provider to make a deferral election within 30 days after he becomes eligible to participate for the first time, but only with respect to compensation for services performed subsequent to the election. Compensation based on a performance period (e.g., an annual bonus), is deemed earned ratably throughout the period, so that a deferral election may be made for a proportionate share, based on the relative length of time before and after the election.

The final regulations include guidance on when a service provider who was previously eligible to participate in a plan can be considered newly eligible for purposes of this rule. First, if all amounts have been paid to a participant and, before the date of payments, the participant became ineligible to accrue new benefits, then if the participant becomes eligible to accrue benefits again, he can be treated as a newly eligible participant. Second, if a participant is ineligible for twenty-four months, but then become eligible again, the participant can be treated as newly eligible, even if is he still entitled to distributions from the plan related to previous participation.

With respect to nonelective “excess benefit plans,” a participant can be treated as newly eligible during the first 30 days of the first taxable year immediately following the taxable year in which the participant first accrues a benefit. The election can apply to amounts accrued for services before the election. For this purpose, “excess benefit plan” is defined as including any nonelective plan that is linked to a qualified employer plan and provides benefits without regard to any limits on benefits under the Code.

Observation
Unlike the proposed regulations, the final regulations do not explicitly apply the plan aggregation principles to the initial eligibility deferral rule. The plan aggregation rules apply for all purposes unless otherwise provided, however, and therefore continue to apply in this context. Thus, for example, a participant who is eligible under one account balance plan and then becomes eligible to participate in a second plan in the same category is not considered a newly eligible participant in the second plan. The definition of excess benefit plan is broader than that used for ERISA. For example, it includes a

plan that provides benefits in excess of the section 401(a)(17) limitation on compensation that may be taken into account under a qualified plan. On the other hand, it excludes any elective plan, as well as any plan that provides benefits in excess of a limit established by its own terms, rather than under the Code.

Performance Pay

Deferral elections relating to performance-based compensation are permitted as late as six months before the end of the performance period, provided that the performance period is at least 12 months long and the service provider performs services continuously from the time performance criteria are established through the date of the election. In addition, the deferral election cannot be made after the amount of compensation has become readily ascertainable.

Compensation is performance-based if it is contingent on pre-established organizational or individual performance criteria. To be pre-established, the criteria must be set forth in writing no later than 90 days after the beginning of the performance period. They do not have to be approved by the service recipient's compensation committee or stockholders.

Subjective criteria are permissible, so long as they are bona fide and related to individual performance or to the performance of a group that includes the service provider. The determination that the criteria have been satisfied cannot be made by: the service provider; a member of his family or the spouse of any family member; or a person under the effective control, or whose compensation is under the effective control, of the service provider or a member of the service provider's family.

As in the proposed regulations, the final regulations provide that "performance pay" can include compensation based solely on an increase in the value of the service recipient or the service recipient's stock after the date of grant. A plan that provides for a payment equal to the value of a specified number of shares is not performance-based compensation merely because the value of the stock determines the amount of the payment. Instead, the compensation must be contingent on attainment of a predetermined value or other performance goal. Finally, this provision does not modify the exception for stock rights, which precludes any additional feature for deferral after the exercise or disposition of the stock right.

A plan may provide both performance pay and other, nonperformance-based compensation. In such a case, it can be bifurcated and the portion meeting the performance pay criteria can be deferred under the special rule for performance pay.

Compensation will not fail to be performance-based merely because it is also payable in the event of death, disability, or a change in control. If the payment is in fact made on the occurrence of one of these events, however, it is not performance-based compensation and a deferral election under these rules is disregarded.

An election cannot be made after the amount of performance-based compensation is readily ascertainable. Where the amount to be paid has been specified, it is readily ascertainable as soon as it is substantially certain the performance conditions will be met. If the amount varies with performance, it is readily ascertainable when both calculable and substantially certain to be paid. These performance-based compensation election rules apply to the extent an amount is not readily ascertainable. Thus, an election may be permissible with respect to a portion of a payment, but not the entire amount.

Observation

Although a deferral election with respect to performance-based compensation may be permitted as late as six months before the end of the performance period, whether it can in fact be delayed that long will depend when the compensation could become readily ascertainable. This issue is more likely to arise with a multi-year performance plan, e.g., if unexpectedly rapid progress toward the goals could dramatically shorten the election period.

As under the proposed regulations, deferral elections with respect to bonuses for newly eligible participants depend on the circumstances. A participant who first becomes eligible under a deferred compensation plan may be able to make an initial deferral election with respect to a bonus, provided that the election is limited to the pro rata portion of the bonus related to the post-election portion of the year. However, a newly eligible participant in a performance pay plan may be unable to defer any of the bonus, even if there are more than six months before the end of the performance period, because he may have started performing services after the performance criteria were established.

Separation Pay

A deferral election with respect to payments on separation from service that are negotiated at arm's length at the time of the separation is timely if made prior to the time the service provider has a legally binding right to the payments.

This provision does not apply to amounts with respect to which there is a legally binding right before negotiations at the time of the separation from service, including a right subject to a substantial risk of forfeiture. For those amounts, the general rules on deferral elections and changes in distribution timing are applicable.

Observation

The election timing provisions of the regulations reflect a more general principle — that a service provider and service recipient have the ability to negotiate the terms of any compensation arrangement, until there is a legally binding right to the amount. This ability does not, however, allow for changes once there is a legally binding right in a manner that would not comply with section 409A.

Commission Income

Sales commissions may be deferred before the beginning of the year in which the customer pays the service recipient. Investment commissions, based on the value of an investment or its appreciation, may be deferred only if the election is made at least 12 months before the commission is determined. Commissions on transactions with parties who are related to either the service provider or the service recipient are ineligible for deferral, unless a substantial portion of the service provider's commission income arises from dealings with unrelated parties and the terms of his compensation are the same for both related and unrelated transactions.

Other Provisions

A special rule allows school teachers and other employees who work for only part of the year on a recurring basis to elect to spread their pay over 12 months without violating section 409A. The election must be made before the service period begins (e.g., before August for a typical teacher) and may not defer compensation beyond the end of the thirteenth month after the beginning of the service period.

Changes in elections under a cafeteria plan are disregarded in determining whether the deferral rules have been complied with, even if the election changes the amount of compensation taken into account in applying a deferral election. The final regulations added this provision to eliminate the potential for failures by plans that exclude section 125 contributions from plan compensation. Elections that comply with the Uniformed Service Employment and Reemployment Rights Act of 1994 are deemed to comply with section 409A.

Amounts that are earned in a final payroll period but paid in the next year are generally treated as compensation for services in the year of payment, with the result that the deferral election in effect for the year of payment can be applied to these amounts. A plan is permitted to adopt a different rule, but it may not take effect until 12 months after the amendment is adopted.

Plans Linked to Qualified Plans or Broad-Based Foreign Arrangements

Under both the proposed and final regulations, if the benefits under a nonqualified plan are calculated using the same formula as a qualified plan, but without regard to limitations imposed on qualified plans under the Code (or other applicable law), or are offset by benefits under a qualified plan, changes in the applicable Code limitations or qualified plan formula generally are not deferral elections or accelerated distributions, even if they result in greater or lesser benefits under the nonqualified plan, provided that the time and form of the nonqualified distributions do not change. The final regulations extend this relief to broad-based foreign plans.

Specifically, none of the following actions or inactions under a qualified plan or broad-based foreign plan has section 409A consequences, even if it affects benefits under a nonqualified plan:

- Action or inaction by a participant that results in the election, elimination, or reduction of a subsidized or ancillary benefit;
- A plan amendment that adds or eliminates a subsidized benefit or ancillary benefit, or that increases accrued benefits or freezes or limits future accruals of benefits;
- A participant's making or failing to make elective deferrals, so long as the resulting increase or decrease in nonqualified deferred compensation does not exceed the section 402(g) limit ($15,500 for 2007, or $20,500 for participants age 50 or older); or
- A participant's making or failing to make the deferrals or employee contributions necessary to obtain the maximum possible matching contributions under the qualified plan, provided that the amount involved does not exceed 100 percent of the amount that would be available under the qualified plan.

The final regulations clarify that the latter two limits are independent of one another. Thus, a section 401(k) wrap plan may allow the amount deferred under the nonqualified plan to be increased by an amount up to the section 402(g) limit and by an additional amount equal to the matching contribution that would be available under the qualified plan. The final regulations also clarify that these limits are increased by the section 414(v) catch-up contribution limit ($5,000 for 2007) if the service provider is at least 50 years old.

Observation

These provisions are significant for excess benefit plans and plans that provide for benefits based on compensation over the section 401(a)(17) limit. Under the regulations, fluctuations in the limits and changes in the individual's compensation that may cause the portion of the benefit covered by the qualified plan to vary do not result in a violation of section 409A. The same result applies to changes to amend the formula under the qualified plan that cause a shift of amounts between the two plans.

For section 401(k) wrap plans and other nonqualified plans linked to qualified plans that provide for deferrals and matching contributions, a shift between the qualified and nonqualified plan is permissible as long as it does not exceed the section 402(g) limit for the year, adjusted for catch-up contributions. For 2007, this amount is $15,500 plus $5,000 for catch-up contributions. In addition, it is permissible to shift up to 100 percent of the amounts that would have been made as matching contributions between the two plans. This is an increase relative to the proposed regulations, which also would have limited the matching contribution shift to the 402(g) limit and affects plans that provide for a match in excess of 100 percent.

Not all plan designs linking qualified and nonqualified plans satisfy the requirements of section 409A. For example, the preamble to the final regulations states that if an employee cannot defer any amount under a nonqualified plan unless he makes the maximum permitted deferral under a qualified plan, and he can freely change the qualified plan deferral, the nonqualified plan does not comply with section 409A. The rationale is that this design is tantamount to letting the employee make a nonqualified deferral election after the beginning of the year, in violation of the deferral rules, since he can negate a timely election by the simple device of reducing his qualified plan deferrals late in the year.

Finally, plan sponsors need to consider general timing issues related to nonqualified plan deferrals. For example, qualified plan deferral elections operate on a “cash basis,” i.e., the deferral election is applied to any amounts that would otherwise be made during the period the election is in effect. For the nonqualified plan, however, the initial deferral rules apply. For example, a nonqualified deferral election made in December 2009 can apply to salary otherwise payable in 2010, but is too late to apply to the 2009 bonus to be paid in March 2010, even though an election under the qualified plan made at the same time would be effective.

Distribution Elections and Changes in Timing of Distributions

Section 409A permits the distribution of deferred compensation only upon the occurrence of one of a limited number of events, requires that the distribution events be specified in advance, and restricts the acceleration of distributions. The final regulations provide additional guidance and flexibility in this area, including additional discretion for payors and protection for service providers from adverse consequences caused by the action or inaction of a service recipient.

Distribution Events

There are six permitted section 409A distribution events (described in more detail below):

- Separation from service (provided that a “specified employee” of a public company may not receive distributions until at least six months after separation);
- A fixed time, or pursuant to a fixed schedule, specified under the plan;
- Death;
- Disability;
- Change in control of a corporation (change in control of a partnership is subject to analogous rules); and
- Unforeseeable emergency.

The final regulations confirm that a distribution does not have to be made immediately on a distribution event: The time of the distribution may be fixed by reference to the event (e.g., six months after separation from service, or three years after death). It is also permissible to base the time of payment on a vesting date.

Distributions do not have to be made precisely on a scheduled day. A payment is treated as timely if it is made after the scheduled date but in the same calendar year or, if later, by the fifteenth day of the third calendar month following the scheduled date. The final regulations also provide that an early payment is timely if made no more than 30 days before the scheduled date. Where a plan states that a payment will be made within a specified period (e.g., within 90 days after a particular date), the first day of that period is the “scheduled date” for purposes of the timing rules. The period must either begin and end in the same taxable year or be no longer than 90 days. If it is possible for a distribution to be made in either of two years, the service provider may not have the ability to designate, directly or indirectly, the year in which a payment will be made. Payment with respect to a stock right occurs on the exercise date.

With two exceptions, a plan may only designate a single time and form of payment with respect to each distribution event. First, for distributions other than at a fixed time or on account of a separation from service, different methods of distribution may be specified for events occurring before or after a fixed or determinable date. For example, a distribution on account of a change of control might be made in a lump sum before age 55 and in the form of a life annuity afterward.

Second, a plan may have different distribution methods for separations from service that occur (1) within two years after a change of control or (2) before or after a stated date, a stated age, or attainment of a stated combination of age and service. An example would be payment in a lump sum upon change of control, payment in five annual installments following separation from service before age 65, and payment as a life annuity following separation after age 65.

Earnings (including dividend equivalents) under a plan may have a different distribution schedule from deferrals, but the schedule must be specified at the same time as the schedule for distributing deferrals, and earnings must be calculated at least annually.

Observation
The regulations provide a number of different rules that allow additional time for distributions or otherwise treat a distribution as made in connection with a permissible distribution event despite the lapse of an interval. Although it is not necessary for all these provisions to be set forth in a plan document, it is important for the plan administrator to understand which time frames apply to which distribution events.

Separation from Service

Separation from service is a permissible distribution event. Generally speaking, separation for an employee occurs at termination of employment; for an independent contractor, when the agreement under which he performs services expires; and for a corporate director, when his term of office ends.

Employees. An employee separates from service when he dies, retires, or otherwise terminates employment. Usually, that event is easy to recognize, but complications may arise when individuals go on leave or reduce their working hours without completely severing their relationship with their employer.

A bona fide leave of absence, including military leave or sick leave, from which the employee is expected to return, is not treated as terminating the employment relationship until the later of the passage of six months (up to 29 months, at the employer's option, in the case of disability leave) or the expiration of any contractual or statutory right to return to employment. Separation occurs at the six-month mark or the expiration of reemployment rights, unless the facts and circumstances indicate that the expectation of a return to employment ended earlier.

The regulations provide somewhat objective standards for determining whether service providers who work reduced schedules have separated from service. An employee is considered to have separated when both he and his employer reasonably anticipate that his services will be permanently reduced to no more than 20 percent of the average level performed over the preceding 36-month period. For purposes of this standard, it is irrelevant whether the continuing services are performed as an employee or as an independent contractor. The regulations do not specify how the "level of services" is measured or what measuring period to use. In most cases, these matters will be intuitively obvious. Otherwise, the parties must act reasonably and in good faith. We are told that an employee on a paid leave of absence should be treated as performing services commensurate with the compensation that he receives, while unpaid leaves that do not result in termination of employment should be ignored in the computation.

If the level of services in fact drops to less than 20 percent of the prior 36-month average, a rebuttable presumption arises that the employee has separated from service. Continuation at a 50 percent or greater level raises a presumption that there was no separation. Levels between 20 percent and 50 percent result in no presumption; whether the employee has separated is purely a matter for facts and circumstances. The presumptions can be rebutted by showing that the parties reasonably failed to anticipate the actual level of services.

For example, if an employee receives a distribution of deferred compensation, purportedly on account of separation from service, but continues to perform services at 50 percent or more of his previous rate, he has a presumptive section 409A violation. The presumption can be rebutted by showing that his services were reasonably expected to fall below the 20 percent level. He might, for instance, have resigned with no intention of returning, then returned to employment after a brief interlude because of unforeseen circumstances.

Similarly, if an employee is presumed to have separated from service because his services have fallen below the 20 percent level, but he has not received a distribution required by the terms of the plan, the parties can show that they reasonably expected his services to continue at a higher level. In that case, separation from service occurs when the parties reasonably anticipate that the lower level of services will be permanent.

A plan may explicitly alter the level of services needed for a separation from service to any percentage greater than 20 percent and less than 50 percent. A plan-created definition must be adopted before deferrals are made and cannot be altered except in accordance with the rules governing changes to the timing of distributions.

Observation
The preamble to the final regulations notes that commenters requested an ability to substitute other definitions of separation from service, in particular to allow use of "terminal leave" or other periods during which an employee continues on the payroll at full-time compensation, but is not expected to resume active services at the end of the leave period. The regulations did not adopt this suggestion. Therefore, employers with terminal-leave or bridge-leave programs will have to determine when a "separation from service" occurs for purposes of section 409A. Note that terminal leave for a "specified employee" could result in violation of the prohibition against making distributions on account of separation from service sooner than six months after separation.

Independent Contractors. For independent contractors, a separation from service occurs on the expiration of all contracts under which services are being provided to a service recipient, provided that the service relationship is terminated completely and the parties do not anticipate its renewal. Under a safe harbor rule, distributions to an independent contractor are deemed to be made on account of separation from service if, under the terms of the plan, they are made at least 12 months after contract expiration and the former independent contractor performs no services for the service recipient, as either a contractor or an employee, during that interval.

Services in More than One Capacity. In general, services in any capacity are considered in determining whether a service provider has separated from service. Hence, for example, serving as a consultant after terminating employment may negate what would otherwise be a separation. The regulations do, however, allow services as an employee to be analyzed separately from services as a corporate director (or as a holder of an analogous position for an unincorporated entity), provided that any deferred compensation plan available to the individual as a director is comparable to plans offered to non-employee directors. Under this rule, continued service on a board of directors will not prevent the receipt of distributions on account of separation from service as an employee. On the other hand, someone who leaves the board may receive a payout of the deferred director's fees even if he remains an employee of the service recipient.

Asset Transactions. Under the final regulations, a sale of assets results in a separation from service for those employees who transfer to the employ of the purchaser. The buyer and the seller in a bona fide, arm's-length transaction may agree that it will not be treated as resulting in separation from service, provided that all affected service providers are treated similarly. The agreement must be made in writing prior to the closing of the transaction. Any such agreement has no effect on whether the transaction is a "change in control" for purposes of section 409A.

Observation

This provision and several others give service recipients considerable flexibility in the context of mergers and acquisitions. An asset sale may, if desired, give rise to distributions on separation from service. Similarly, as is discussed below, a stock sale, which cannot be regarded as resulting in separation from service, may be an occasion for terminating deferred compensation plans and making immediate distributions. In either situation, consistency requirements are applicable. In addition, payments can be made for a change in control, a distribution event that can apply to either a stock or asset sale.

Separation from Service and Specified Employees. Specified employees may not receive distributions on account of separation from service until at least six months after the separation occurs (or upon death, if earlier). A plan that provides for installment or annuity distributions may comply with this requirement either by delaying the commencement of distributions for six months, or by making a catch-up distribution of the first six months of payments at the beginning of the seventh month.

The elements of the definition of "specified employee" have been borrowed from the qualified plan definition of "key employee" in section 416(i). The most significant difference is that an individual may be a specified employee only if the service recipient for which he works has publicly traded stock as of his separation from service. The stock may be any class of stock of any member of the service recipient's controlled group and may be traded "on an established market or otherwise." The concept of "publicly traded" is somewhat broader than the concept of "readily tradable" used for purposes of setting the exercise price for stock rights.

An employee of a service recipient with publicly traded stock is a "specified employee" if he (1) owns more than 5 percent of the stock of the service recipient or of any member of its controlled group; (2) owns more than 1 percent of the stock and has compensation from the service recipient in excess of $150,000 per year (not indexed); or (3) is an officer of the service recipient with compensation in excess of $145,000 per year (indexed). Officer status is based on the nature of one's duties, not on title, and is limited to the 50 highest-paid officers.[3]

The compensation used to identify specified employees is defined under section 415. By default, none of that section's safe harbors, special timing rules, or other special rules are used; but a plan may incorporate any of them, without regard to how the service recipient's qualified plans define section 415 compensation. The definition must be consistently applied to all employees.

Observation

Under the default definition of compensation, non-U.S.-source compensation of nonresident aliens is ignored. Multinational companies will want to consider whether to include it. While there may be some additional administration associated with including non-U.S.-source compensation, the effect will ordinarily be to reduce the number of U.S. officers included in the specified employee group.

As an administrative convenience, the final regulations allow plans to devise alternative methods for identifying specified employees. The method must be reasonably designed to include everyone who would be a specified employee under the statutory method, use an objectively determinable standard that does not give any service provider a direct or indirect election regarding its application, and result in no more than 200 service providers being identified as of any date.

Specified employees must be identified each year as of a uniform "identification date" selected by the employer. The facts concerning stockholdings, compensation, and officer status as of that date identify the specified employees, but the identifications do not become effective until the beginning

[3] The limit on the number of officers is 10 percent of all employees if the corporation has 30 to 500 employees. If a corporation has fewer than 30 employees, it is limited to three officers.

of the fourth calendar month after the identification date, or an earlier date chosen by the employer. The identified individuals then remain specified employees for the next 12 months.

A service provider's criteria for specified employee status may be changed, but changes cannot be effective until 12 months after their adoption.

Observation

A plan document must include a provision that requires a six-month delay for distributions on separation from service to a specified employee. The regulations provide different ways for employers to identify specified employees, but require that these provisions be applied consistently. If a plan does not include provisions for identification of specified employees, the default rules will apply.

The final regulations clarify that the six-month delay applies only if the service provider is a specified employee upon separation from service. Thus, it does not affect someone who would have become a specified employee if he had not separated from service. If specified employees leave between the identification date and the date on which the identifications become operative, they are not replaced. Suppose, for example, that the 50 highest-paid corporate officers are identified as specified employees on the basis of the facts that exist on a December 31, 2008, identification date. The identification effective date is April 1, 2009. On March 1, 2009, an officer who was not a specified employee as of the prior year's identification date separates from service. He is not subject to the six-month distribution delay, because he is not yet effectively a specified employee. Moreover, as of April 1, 2009, the company will have only 49, not 50, specified employees.

The final regulations also clarify that if a payment on account of separate from service is subject to the six-month delay, acceleration is permitted only in the event of death, and not on account of disability, change in control, or an unforeseeable emergency during the six-month hiatus.

The final regulations provide special rules for identifying specified employees in the context of corporate transactions. The following chart summarizes these rules:

Transaction Type	Next Identification Date	Next Effective Date	Specified Employees Between Transaction Date and Next Effective Date
Merger of two or more public corporations or One public corporation becomes a subsidiary of another	Date surviving or acquiring corporation would have been required to use absent the transaction	Date surviving or acquiring corporation would have been required to use absent the transaction	50 highest-compensated specified employees on the entities' combined lists as of the transaction date plus any 1- and 5-percent owners who are not among the 50 highest paid[4]
Public and private corporation merge and become public or Private corporation becomes a subsidiary of a public corporation	Date the pre-transaction public corporation would have been required to use absent the transaction	Date the pre-transaction public corporation would have been required to use absent the transaction	Specified employees of the pre-transaction public corporation immediately before the transaction

[4] The service recipient may use any other reasonable method if adopted within 90 days after the transaction and applied prospectively.

Transaction Type	Next Identification Date	Next Effective Date	Specified Employees Between Transaction Date and Next Effective Date
Spin-off of a public corporation from another public corporation	Date the pre-transaction public corporation would have been required to use absent the transaction	Date the pre-transaction public corporation would have been required to use absent the transaction	Specified employees of the pre-transaction public corporation immediately before the transaction
All or part of a private-service recipient becomes one or more public corporations (e.g., IPO)	The next December 31, unless the new public corporation elects, before the transaction date, to use a different date	April 1 after the identification date, unless the new public corporation elects, before the transaction date, to use a different date	Service providers that at the time of the transaction would have been specified employees of the private-service recipient using the same dates selected by the subsequent public corporation

Fixed-Time (or Pursuant to a Fixed Schedule) Specified Under The Plan

A plan may provide that distributions will be made on a fixed date, or during a specific calendar year. Also permitted is distribution in installment or annuity form pursuant to a fixed schedule. The schedule can be linked to a specified date, to another permissible distribution event, or to the date on which a substantial risk of forfeiture lapses. A plan might, for instance, provide that deferred compensation will be forfeited if the service provider leaves within 10 years, unless the service recipient has an earlier IPO. It could then provide that, upon vesting (the earlier of the completion of 10 years of service or the IPO date), the deferral will be distributed in installments over five years. When a vesting date is used as the basis for a fixed schedule, however, the parties may not voluntarily accelerate vesting as a way of accelerating the payout. Instead, even if vesting is accelerated, the distribution must follow the vesting schedule as initially set out in the plan.

A distribution date is not fixed, and does not comply with section 409A, if it is not currently ascertainable or is contingent on an event whose time of occurrence is not already known. A plan could not, for instance, specify “the date (or year) on which profits reach X” or “the date of the employer’s IPO” (unless those events also constitute vesting conditions).

The final regulations provide additional guidance on the structure of permitted distribution schedules. Installments may be calculated using an objective and nondiscretionary formula, such as the one used for determining minimum required distributions for defined contribution plans. A formula may include a cap on each year’s distributions, either to an individual or to a group, provided that the cap is objective and nondiscretionary, and the plan includes a nondiscretionary formula for allocating any required reductions. For example, if a plan provides that payments to all service providers cannot exceed 10 percent of profits in any year, it would also have to state how that limit will be implemented, e.g., through a pro rata reduction of all participants’ distributions. A formula may also offset benefits by Social Security benefits or payments under a disability plan, despite the fact that the future amounts of those reductions may be currently unknowable, provided that these adjustments result in forfeiture rather than merely in deferral of the scheduled payment to a later date and that any disability offset is under a plan that covers a substantial number of service providers and was established before the particular service provider became disabled.

A plan that reimburses expenses or provides in-kind benefits, such as a post-retirement medical plan, is treated as distributing benefits in accordance with a fixed schedule if it sets forth an objective, nondiscretionary definition of the benefits, states the period over which they will be paid, provides that benefits in one year do not affect those payable in any later year, and does not allow benefits to be cashed out or exchanged for other benefits. In addition, reimbursements must be paid no later than the end of the taxable year after the year in which the reimbursable expense is incurred.

Medical plans may include lifetime limits on benefits or other maximum benefit levels. For a health reimbursement account, the maximum dollar credit available under the plan is a permitted form of maximum benefit.

Tax gross-up payments are also considered to provide for distributions on a fixed schedule if the payments are made no later than the end of the year following the year in which the underlying taxes are paid. A similar rule applies to a right to reimbursement for expenses incurred in defending an audit or litigation related to tax liability.

As under prior guidance, it is not permissible for distributions to be triggered by an event whose date of occurrence is uncertain, such as the sale of an asset. The regulations also do not allow payments to a service provider to track receipts by a service recipient, subject to a limited exception that allows payments to be linked to sales made in the ordinary course of business.

Observation
The expanded guidance on what constitutes a fixed schedule will make compliance easier for formula-based plans, but plans that link distributions to a liquidity event, such as the sale of developed property, will need to be revised, unless the liquidity event also entails a substantial risk of forfeiture, such as a requirement that proceeds of sale exceed a certain level or that the service provider be actively providing services at the time of the event.

Disability

For purposes of the distribution rules, “disability” is defined as inability to engage in any substantial gainful activity or the receipt of benefits for at least three months under an employer’s disability plan as the result of a medically determinable physical or mental impairment that is expected to result in death or continue for at least 12 months. The service provider need not receive a Social Security disability determination, although that is acceptable proof of disability. A plan may substitute a definition that is more limited than that provided in the regulations.

Observation
The regulations do not allow the service provider to have any discretion over the determination of disability or the right to receive disability benefits. Usually, of course, a disabled service provider will also separate from service and will be entitled to distributions on account of that event. It is possible, though, for an employee to be placed on disability leave for as long as 29 months before he must be deemed to have separated from service. Also, a specified employee who becomes disabled may receive distributions immediately on account of disability but only after a six-month delay on account of separation from service. The strategic course of action, if the delay would be a hardship, is to postpone separation from service by granting disability leave, then commence distributions under the plan’s disability provisions.

Death

Observation
Although little additional guidance is needed about death, the general rule that allows payments to be made by the end of the calendar year or, if later, two-and-a-half months after the event

triggering the right to a distribution, applies. This rule, along with other guidance discussed below regarding events outside of the service provider's control, allows additional time to make distributions on account of death and reduces the risk that the section 409A additional tax will be imposed on those payments.

Change in Control

The provisions of the final regulations generally follow the proposed regulations. As in previous guidance, the regulations address corporate transactions only; taxpayers may apply the rules for corporations to partnerships by analogy pending further guidance. In addition, a nonstock, nonprofit corporation may apply the change in effective control provisions (relating to a change in the composition of the board of directors) by analogy.

A change in ownership or control occurs with respect to a service provider only if the change relates to the corporation to which he provides services, or to the one that is liable for payment of the compensation (assuming that there is a bona fide business reason for its making the payment), or to one that is further up in a chain of corporations, each of which is majority-owned by its parent. There are three types of change in control, each based on distinct criteria:

- *Change in ownership.* A change in ownership occurs if a person, or a group of persons acting together, acquires more than 50 percent of the stock of the corporation, measured by voting power or value. Incremental increases in ownership by a person or group that already owns 50 percent of the corporation do not result in a change in ownership.

- *Change in effective control.* A change in effective control occurs if, over a 12-month period, (1) a person or group acquires stock representing 30 percent of the voting power of the corporation (reduced from 35 percent under the proposed regulations) or (2) a majority of the members of the board of directors of the ultimate parent corporation is replaced by directors not endorsed by the persons who were members of the board before the new directors' appointment.

- *Change in ownership of a substantial portion of corporate assets.* A change in control based on the sale of assets occurs if a person or group acquires 40 percent or more of the gross fair market value of the assets of a corporation over a 12-month period. No change in control results if the assets are transferred to certain entities controlled directly or indirectly by the shareholders of the transferring corporation.

It is possible for more than one corporation involved in a transaction to have a change in control for purposes of section 409A. A plan is permitted to provide a narrower definition of a change in control by increasing the percentages otherwise applicable under the provisions outlined above.

A plan sponsor may retain the discretion to terminate an arrangement in the event of a change in control, provided that it acts during the period beginning 30 days before and ending 12 months after the change and that it terminates all plans that are treated as a single plan under the aggregation rules for all participants affected by the change in control.

Delayed payments for the purchase of stock upon a change in control (e.g., earn-out payments) are treated as paid in conformity with the distribution and the deferral election requirements so long as they are made on the same schedule and under the same terms and conditions as payments to selling shareholders generally and within five years of the change in control. Alternatively, post-termination payments that are subject to a substantial risk of forfeiture may be made under the short-term deferral rules.

The regulations allow a substantial risk of forfeiture to be extended in connection with a change in control, without regard to the general rule that disregards any extensions made after the service period begins.

Unforeseeable Emergency

The statute’s definition of “unforeseeable emergency” is based on the regulations under section 457: severe financial hardship arising from illness or accident of the service provider, spouse, or dependents; casualty loss; or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. No hardship is considered to exist, however, to the extent that the financial need can be relieved through reimbursement or compensation from insurance or otherwise, by liquidation of the service provider’s assets to the extent the liquidation would not itself cause severe financial hardship, or by the cessation of deferrals under qualified and nonqualified plans. Examples of events that do not meet this standard are divorce and enrollment of a child in college. Finally, the amount distributed may not be more than is reasonably necessary to meet the emergency and pay any anticipated tax on the distribution.

The final regulations clarify that neither the ability of a service provider to decide whether to seek a distribution on account of an unforeseeable emergency nor the service recipient’s retention of discretion over whether to allow the distribution constitutes an impermissible acceleration or deferral of a distribution.

Coordination of Multiple Distribution Events

A plan may provide for payment upon more than one distribution trigger. For example, it may state that distributions will begin upon the earliest of death, disability, an unforeseeable emergency, or attainment of age 62, or on the later of separation from service or attainment of age 70, with acceleration in the event of death.

When a distribution is made over a period of time, it may be accelerated by the occurrence of a new triggering event. For example, a plan may provide for payment of a series of 10 installment payments after separation of service, but require payment of the remaining installments in a lump sum if the participant dies or becomes disabled, or if the corporation undergoes a change in control. An exception, already noted, is that only death can accelerate a specified employee’s distribution on account of separation from service into the six-month period following separation.

Plans Linked to Qualified Plans or Broad-Based Foreign Arrangements

The regulations do not permit distributions under a nonqualified deferred compensation plan to be determined by distributions under a related qualified or other tax-favored plan. Transition relief that allowed nonqualified benefits to be distributed in the same form as elected under a related qualified plan expires at the end of 2007. As a result, post-2007 accruals under nonqualified plans will have to be distributed in accordance with a separate election, made prior to deferral or December 31, 2007, without regard to any elections made under the qualified plan.

The regulations provide exceptions to the deferral and distribution rules related to nonqualified plans linked to qualified plans or to broad-based foreign arrangements. These provisions are discussed above in connection with deferral elections.

Offsets

The final regulations provide that deferred compensation payments may be offset by amounts owed to the service recipient by the service provider if the debts were incurred in the ordinary course of business, the entire offset in any year does not exceed $5,000, and the offset is taken at same time and in same amount as debt would have been due. Also permitted are dollar-for-dollar offsets to reflect Social Security or disability benefits, as discussed above in connection with fixed payment schedules.

Changes in Time and Form of Distribution

The date on which distributions will commence may be postponed (whether the postponement is at the election of the service provider or the service recipient) if the following conditions are met:

- The election to delay must be made not less than 12 months before a scheduled payment,
- The election may be effective no earlier than 12 months after it is made. If a distribution event occurs in the interim, the original distribution method must be followed.
- The postponement must be for at least an additional five years. Distributions on account of death, disability, or unforeseeable emergency may be postponed for shorter periods.

Postponement elections apply to each distribution event separately. For instance, if the plan makes distributions upon the earlier of separation from service or attainment of age 65, then the fixed date could be changed to age 70 without affecting the timing of the distribution if the participant separates from service.

Compliance with the preceding conditions is evaluated on a payment-by-payment basis. What constitutes a "payment" depends on the terms of the plan. If a distribution is to be made in the form of a series of installment payments, the plan may treat the entire series as a single payment, commencing on the date of the first installment, or each installment as a separate payment. The latter approach allows postponement of the receipt of particular installments without the need to delay the entire series. If the installments are designated as a single payment, individual installments may not be postponed. On the other hand, the entire series may be converted into a lump sum, payable no earlier than five years after the initial installment was originally due.

Where a distribution is to be made in annuity form (that is, where the length of the distribution period depends, in whole or in part, upon one or more lives), individual payments may not be postponed separately. Because the annuity is a single payment, it also may be converted into a lump sum payable no earlier than five years after the annuity starting date.

The preceding rules also apply to distributions initially designated as short-term deferrals not subject to section 409A. An election to postpone distribution beyond two-and-a-half months after the end of the year in which vesting occurs must comply with either the initial deferral rules or the postponement rules.

The postponement rules are keyed to the date on which the distribution would otherwise be made. If the distribution may take place on any date within a particular period, the earliest possible date is assumed to be the original distribution date.

The same rules apply to plan amendments that have the effect of changing the timing of distributions. For example, an amendment to change the definition of "separation from service" under a plan must be implemented as if it were an election to postpone distributions.

Life Annuities

An election to change from one life annuity form of distribution to another that is actuarially equivalent is not restricted by the rules governing changes in the timing of distributions. The following features do not prevent a form of distribution from being classified as a "life annuity," though they are taken into account in determining whether the forms are actuarially equivalent:

- Term certain features;
- Pop-up features (e.g., under which payments increase upon the death of the beneficiary);
- Cash refund features;
- Leveling features with respect to Social Security or Railroad Retirement Act benefits; and

- Cost-of-living adjustments, subject to the same limitations as apply under the minimum distribution rules of section 401(a)(9).

Actuarial equivalence must be determined consistently, but the actuarial assumptions may change over time.

A subsidized joint and survivor annuity is treated as actuarially equivalent to a single life annuity unless the survivor percentage exceeds 100 percent. For example, a single life annuity of $5,000 a month is deemed to be actuarially equivalent to one that pays $5,000 a month to the service provider and any amount up to $5,000 a month to his survivor.

A service provider’s survivor annuitant may be freely changed at any time before the annuity begins, so long as any consequent change in scheduled payments reflects only the life expectancy of the new beneficiary.

Additions of Payment Events and Amendments

The addition of a new distribution event, other than distribution on the earliest of death, disability, or unforeseeable emergency, is treated as an acceleration or postponement of distributions. If it is an acceleration, it violates section 409A, unless it meets one of the exceptions discussed below. If it is a postponement, it must comply with the rules discussed above.

The final regulations provide additional guidance on situations in which payments will be considered accelerations of deferred compensation. In particular, a cancellation or forfeiture of deferred compensation may be a disguised acceleration or postponement if the same benefit is then provided under a different guise. An example is the replacement of a distribution due on account of a separation from service by a purported section 409A-exempt separation pay plan in order to avoid the rule preventing distributions on separation from service to a specified employee for six months.

Permissible Delays

The regulations provide relief in many situations in which delay in payment is unanticipated or is outside the control of the service provider. These exceptions protect service providers against unintended violations of section 409A, provided that payment is made promptly once the cause of the delay is removed. In all cases, delay is impermissible if it is at the explicit or implicit request of the service provider or if the service recipient treats similarly situated service providers on a basis that is not reasonably consistent.

Delaying a distribution is permissible under these circumstances:

- A payment may be delayed if making it would jeopardize the ability of the service recipient to continue as a going concern. This standard is somewhat more relaxed than the proposed regulations, which would have permitted a delay only if the payment jeopardized the solvency of the service recipient.

- A service provider is not treated as violating section 409A if the service recipient refuses or, intentionally or inadvertently, fails to pay. In this situation, the service provider must take reasonable steps to enforce payment by notifying the service recipient within 90 days, and by taking further enforcement action within 180 days, after the payment is due. Failure to do so would suggest a voluntary, rather than an involuntary, delay.

- Any delay is permitted as necessary to comply with applicable law, such as federal securities laws.

- If a distribution at the scheduled time would be nondeductible under section 162(m), it may be delayed until either the first year in which it is deductible or separation from service (six months after separation from service for a specified employee). Either date may be selected, and the date may be different for different distributions. If the distribution is on separation from service, it must be made by the end of the year of separation, or if later, within two-and-a-half months after separation. (For a specified employee, the six-month delay period applies.)

- Payment may be delayed if the calculation of the amount to be paid is administratively impracticable due to events beyond the control of the service provider. The service provider may not cause the delay, as by failing to provide needed, reasonably available information to the person performing the calculation.

Acceleration of Distributions

The statute prohibits any acceleration of a distribution, except as provided in regulations. The final regulations set forth the exceptions described below. Note that, in all cases, the service provider may have no say in whether the acceleration occurs. The decision must be made by the service recipient or automatically under the terms of the plan.

Acceleration of De Minimis Distributions. A plan may give a service recipient discretion to cash out a service provider's interest at any time, or may provide for automatic cashouts under specified circumstances, such as separation from service, so long as the value of the interest does not exceed the section 402(g) limit ($15,500 in 2007) and all arrangements that fall into the same category of plan are cashed out at the same time. A plan amendment calling for distributions under these circumstances may be adopted at any time before the date of the payment.

A plan may also provide that scheduled installment distributions will be cashed out if their present value is less than a plan-established threshold, which may be any amount desired. A plan amendment adding a provision of this sort must comply with the restrictions on amendments that postpone distributions.

Acceleration to Comply with Legal Requirements or Pay Taxes. Plans may provide for accelerated distributions:

- To comply with a divorce decree or domestic relations order;
- To comply with federal, state, local or foreign conflicts of interest or ethics requirements;
- To withhold taxes imposed as a result of income inclusion under section 457 resulting from the vesting of benefits under a plan of a governmental or tax-exempt employer;
- To pay applicable employment taxes and withhold income taxes on any distribution made in accordance with the terms of the plan;
- To pay applicable employment taxes and withhold income taxes on any amount required to be included in income upon failure to comply with section 409A; or
- To prevent the occurrence of a nonallocation year (section 409(p)) with respect to an employee stock ownership plan sponsored by an S corporation.

Accelerated Payments on Termination of the Plan. The final regulations allow a service recipient to terminate a plan and make accelerated distributions, but only if certain requirements are satisfied:

- All arrangements that fall into the same category of plan must be terminated with respect to all service providers who participate in them.
- Distributions on account of the termination may be made no earlier than 12 months after all action necessary to make the termination effective has been completed.
- All distributions must be completed no later than 24 months after the date of termination.
- The service recipient may not establish any new arrangements of the same type for any service provider within three years following the date of termination.

- The termination may not “occur proximate to a downturn in the financial health of the service recipient.”

Employers that are in financial difficulty may terminate plans and accelerate distributions only with the approval of a bankruptcy court. Distributions in that case must be made in the year of termination or, if later, the year in which participants’ interests become vested. Distributions may be delayed if immediate payment is not administratively feasible.

Termination is also permitted upon a corporate liquidation taxable under section 331, with the approval of a bankruptcy court, or during the period beginning 30 days before and ending 12 months after a change in control, provided that all distributions are made within 12 months after the termination date.

Substitutions

A forfeiture or voluntary relinquishment of a scheduled payment is not treated as a payment so long as nothing is substituted for it. Whether a substitution has occurred depends on the facts and circumstances. Payment proximate to the forfeiture or voluntary relinquishment is presumed to be a substitute. This presumption can be rebutted by showing that the amount would be received in any event. Factors include whether the amount that purportedly replaces the deferral was paid in accordance with a customary practice or is materially less than the forfeited or relinquished amount.

Transition to Final Regulations

Introduction

Section 409A is effective January 1, 2005, and applies to amounts deferred after December 31, 2004, and to deferrals prior to January 1, 2005, if the plan under which they were made is materially modified after October 3, 2004. A deferral is considered to have been made before January 1, 2005, only if the service provider had a vested, legally binding right before that date. Initial transition guidance was set forth in Notice 2005-1. This guidance was modified and extended by the preamble to the proposed regulations and by Notice 2006-79.

During the transition period, taxpayers are required to operate in good-faith compliance with the previously issued notices and the statute. Compliance with the proposed regulations or the final regulations is not required prior to January 1, 2008, when the final regulations become applicable, but will be considered good-faith compliance with the statute.

For most arrangements, the transition period expires on December 31, 2007. The period expired on December 31, 2006, however, for options with a below-fair market value exercise price granted to employees subject to the section 16(a) of the Securities Exchange Act of 1934, unless the grants were properly reported on the employer's financial statements.

Good-Faith Compliance Through December 31, 2007

By December 31, 2007, taxpayers need to ensure that the following steps are completed:

- Plans that may provide deferred compensation should be identified and either brought into compliance with section 409A or revised to fit one of the exceptions (e.g., for short-term deferrals or stock rights).
- Plan documents should be reviewed, with particular attention to terms related to amount of deferral, timing of distributions, election procedures (for initial and redeferral elections), and specified employee restrictions. For distributions, it will be important to consider whether a series of installment payments should be designated as a single payment or a series of individual payments.
- Any last opportunity to change distribution elections must be provided by December 31, 2007, subject to the restriction that distribution election changes cannot defer amounts otherwise payable in 2007 to a later year and cannot make amounts otherwise payable in a later year payable in 2007.
- Procedures should be in place to (1) protect grandfathered deferrals and (2) identify future arrangements that may result in deferred compensation as entered into or adopted.

Actions that can be taken during the transition period are discussed further below.

Plan Documents in Effect Prior to January 1, 2008

Taxpayers are required to substantiate operational compliance with section 409A during the transition period. The preamble to the final regulations provides that taxpayers are not required to retroactively amend plan documents for compliance; instead, it is sufficient for documents to be amended effective for periods beginning on or after January 1, 2008.

Observation

Eliminating the requirement to retroactively amend plan documents removes what could have been a tremendous administrative burden for taxpayers. For example, it will be sufficient to demonstrate that elections were in fact timely made, without the need for plan amendments to add timing requirements for these prior elections.

Transition for Actions Taken Prior to January 1, 2008

As the rules have evolved from Notice 2005-1 to the final regulations, taxpayers have been able to take positions in good faith that will not be permitted under the final regulations. The preamble outlines the extent to which these positions may be relied on beyond the expiration of the transition period.

- *Initial deferral elections.* Initial deferral elections that satisfy the good-faith compliance requirement do not have to be revised. This includes elections with respect to performance-based compensation, as defined under Notice 2005-1, or the proposed or final regulations. In addition, for arrangements established before April 10, 2007, elections in 2008 will be deemed to comply if made by a deadline established by the plan that is a reasonable good-faith interpretation of the statute and the notices. Elections after 2008 will need to be made by December 31, 2008.

- *Timing and form of distributions.* These elections do need to be revised, even if the timing or form selected complies with prior guidance. For example, if a formula for determining installment payments does not satisfy the final regulations, it will need to be revised prior to December 31, 2007, with respect to payments to be made after the end of the transition period.

- *"Separation from service."* A previous good-faith interpretation as to whether separations have or have not occurred will be respected. If, however, a service provider was determined not to have separated from service under prior guidance, but has separated from service under the final regulations, distributions need to commence by the end of 2007.

- *"Specified employees."* A good-faith identification of specified employees will be respected for any separation from service prior to January 1, 2008. This relief applies without regard to whether the six-month delay period would extend into 2008.

- *Stock rights.* Stock rights granted prior to April 10, 2007, that were granted on a class of stock permissible under Notice 2005-1 or the proposed regulations, can remain outstanding pursuant to their terms even if options on that class are not permitted under the final regulations. Extensions prior to October 23, 2004, the date of enactment of the AJCA, have no adverse consequences under section 409A. Extensions granted before April 10, 2007, are also respected, without regard to the final regulations, unless they result in a deferral of income to a year after the year of exercise.

Observation

As noted above in connection with the ongoing rules for stock rights, because Notice 2005-1 did not include the limitations on permissible class of service recipient stock, this relief allows employers who issued grants on preferred stock or strips of common and preferred to leave those grants outstanding without exposing the employees to liability under section 409A. A plan that provides for these grants will have to be revised immediately, however, to shift to grants on a permissible class of stock as defined in the final regulations.

Grandfathered Deferrals

In general, deferred compensation is exempt from section 409A to the extent that the service provider is entitled to receive it, without any substantial risk of forfeiture, after December 31, 2004, and the plan has not been materially modified after October 3, 2004. Earnings with respect to a grandfathered deferral are also exempt.

A consequence of these principles is that a deferral is eligible for grandfathering only if the participant acquired a legally binding right to it no later than December 31, 2004, and it was not subject to a substantial risk of forfeiture as of that date. For this purpose, “substantial risk of forfeiture” is defined in the section 83 regulations, not in accordance with the narrower section 409A definition.

Observation

The use of the section 83 definition of “substantial risk of forfeiture” means that deferrals that are subject to noncompete agreements or were made electively or reflect past extensions of the vesting period are not eligible for grandfathering and must comply with section 409A. For purposes of the section 409A deferral and distribution rules, however, they are treated as vested. For example, if a service provider’s vesting period was originally scheduled to end on December 31, 2003, but was extended by agreement until December 31, 2008, the deferral is not grandfathered, because it is unvested under section 83 concepts. On the other hand, because it is not subject to a section 409A substantial risk of forfeiture, it cannot take advantage of such provisions as the short-term deferral exemption. This rule is of particular importance for section 457(f) plans, where extensions of vesting period are not uncommon.

Clarifying an ambiguity in the notice, the proposed regulations stated that a plan provision under which a service provider’s ability to exercise stock options or similar rights expires upon termination of employment does not create a substantial risk of forfeiture. Hence, such an option is not subject to section 409A if the holder’s rights were otherwise vested as of December 31, 2004.

The actual amount covered by the grandfather is determined by reference to the type of plan. For an account balance plan, it is the December 31, 2004, account balance, plus future earnings (such as notional interest) credited under the terms of the plan.

For equity-based compensation plans, the grandfathered amount is equal to the value of the participant’s rights on December 31, 2004, including future appreciation and dividends or dividend equivalents attributable thereto.

For nonaccount balance plans, the grandfathered benefit is the benefit under the plan formula through December 31, 2004. That benefit may include early retirement or other subsidies for which the participant is qualified after that date, so long as they were not added to the plan by an amendment adopted after October 3, 2004. For purposes of calculating the present value of a benefit, reasonable actuarial assumptions and methods must be used, determined as of each date the benefit is valued.

For example, a plan might provide that a participant’s accrued benefit equals 2 percent of final annual compensation multiplied by years of participation, payable in the form of a life annuity beginning at age 65. If benefits commence before age 60, they are actuarially reduced to reflect early commencement, but there is no actuarial reduction after that age. A participant could, under the terms of the plan in effect on October 3, 2004, elect the time and manner of payment at any point before termination of employment. As of December 31, 2004, a 45-year-old participant had completed 10 years of service and had annual compensation of $400,000. The accrued benefit at that point was 20 percent of $400,000, or $80,000 per year beginning at age 65. The participant may, under the grandfather rules, make a distribution election with respect to that benefit until the date of retirement. If the participant elects to commence benefits before reaching age 60, the grandfathered amount will be subject to actuarial reduction. After that, it will equal the full $80,000 a year, possibly adjusted for the form of benefit (e.g., a joint-and-survivor annuity).

Material Modifications

If a plan is materially modified after October 3, 2004, with respect to otherwise grandfathered amounts, those deferrals become subject to section 409A. The proposed regulations and the notice are generally similar, although the notice provides more information and some clarifications as to what constitutes a material modification.

Material modifications are changes to a plan, either by amendment or exercise of discretion, that enhance or add a benefit, right, or feature that is valuable to participants, even if the new right is permitted by section 409A, or that attempts to grandfather a benefit that would otherwise be subject to section 409A. For example, an amendment adopted after October 3, 2004, that accelerated vesting from a date in 2005 or later to December 31, 2004, does not evade section 409A's application. The addition of a haircut provision to a benefit earned and vested by December 31, 2004, would also be considered a material modification, and amounts deferred under the plan would lose their grandfathered status and become fully subject to section 409A. On the other hand, it is not a material modification for a service recipient to exercise discretion under the plan (for example, to terminate the plan and pay out all accrued benefits), or for a service provider to exercise a right under the plan (for example, to elect a date of distribution that would not be permitted under section 409A) if those rights derive from the plan terms as of October 3, 2004.

For account balance plans, changes in the method of calculating earnings under a plan generally are not material modifications if the change involves an actual predetermined investment or a reasonable interest rate (determined by reference to regulations under section 3121(v)(2) (relating to FICA taxes on deferred compensation)). For example, if earnings are credited using a bond index, a different index could be substituted, or the investment return on a particular mutual fund or stock portfolio could be used instead.

Benefits granted after October 3, 2004, are eligible for grandfathering if they vested by the end of 2004 and were consistent, on a facts-and-circumstances basis, with the service recipient's prior compensation practices. For instance, a fully vested grant of SARs in November 2004 that is consistent (in terms and amounts) with grants made each November for the past several years would be eligible for grandfathering.

Additional benefits that were added after October 3, 2004, and do not qualify for grandfathering, are subject to section 409A, but the section affects only the incremental benefits, not the entire amount accrued under the plan. The provisions of the plan with respect to the nongrandfathered benefits can be revised to comply with section 409A in accordance with the general transition rules.

Amendments to a plan to bring it into compliance with section 409A are not material modifications. Thus, to the extent that amounts deferred under a plan are subject to section 409A and are brought into compliance during 2005, these changes do not constitute material modifications that taint otherwise grandfathered amounts.

The final regulations also list several changes to a plan that are not considered material modifications:

- The establishment of or contributions to a rabbi trust (a trust whose assets are subject to the claims of the service recipient's general creditors), other than a trust that would fail to comply with section 409A(b) (offshore and trusts with financial health triggers);
- Any amendment need to comply with a domestic relations order;
- Amendments that add additional forms of annuity distribution to a plan that already provides for that form; and
- The addition of a limited cash-out feature consistent with the regulations.

Observation
The definition of "material modification" makes clear that changes to enhance a grandfathered benefit, either in amount or with respect to other features such as timing of distributions, will result in the deferred amount being treated as a post-effective date deferral. To the extent that preserving the grandfather is important, employers will need to administer these arrangements carefully to ensure that the terms of any post-effective date plan are not accidentally applied to grandfathered benefits.

Transition Relief

Notice 2006-79 extended transition relief through the end of 2007, with the exception of certain discounted options granted by public companies to employees subject to section 16(a) of the Exchange Act. As noted above, it is no longer a condition of transition relief that a plan document be amended retroactively to January 1, 2005. It is important, however, to be able to substantiate operational compliance with section 409A and the transition guidance.

Changes in Payment Elections

During the transition period, plans may allow participants to make new elections altering the timing of distributions, the form in which benefits will be paid, or both. New elections may be made for deferrals subject to section 409A and to short-term deferrals. Either postponement or acceleration is allowed, provided that an election during 2006 could not postpone a distribution that would otherwise be made in 2006, and could not accelerate a distribution otherwise scheduled for a later year into 2006. The same restriction applies to payments relative to 2007.

This relief applies both to deferrals subject to section 409A and to deferrals that would be grandfathered but which the employer elects to ungrandfather and make subject to section 409A. Because the definition of "plan" applies on a service-provider-by-service-provider basis, different decisions may be made with respect to different service providers. Thus, an employer may offer each employee the option of either terminating an arrangement or agreeing to revisions, or, if permitted by the provisions of the plan, unilaterally make the decision for all employees. Similarly, the employer may limit the range of choice available to participants. They might, for instance, be given only the option to leave distributions as they are, or cash them out in 2008.

Observation
The ability to change distribution timing also is available for an amount that would otherwise be a short-term deferral. Thus, for example, the distribution date for a bonus payable under a bonus plan that would be a short-term deferral, rather than deferred compensation, may be changed. Such an election must comply with the general rules, e.g., that an election in 2007 cannot delay payment of an amount otherwise scheduled to be paid in 2007.

Revocations of Deferral Elections

During 2005, prior elections to defer compensation could be revoked, and plans were permitted to give participants the right to terminate participation in the deferral arrangement and accelerate all of their distributions to this year. These provisions expired at the end of 2005 and were not extended.

Similarly, a plan that did not have a termination clause as of October 3, 2004, could be amended by the end of 2005, and terminated in 2005.

Observation

Once the 2005 transition rule expired, changes during the remaining transition period could be made only with respect to distributions otherwise payable in a later taxable year. Thus, in 2007, it would not be permissible to revoke an election to defer compensation to a later year and receive payments in 2007. A participant could be permitted to elect to receive the distribution of these amounts in 2008, however. In public comments, representatives of the IRS and Treasury have cautioned that the doctrine of constructive receipt continues to apply to transition elections. Its effect in this context is not clear.

Application to Stock Rights

A nongrandfathered stock right that was granted with an exercise price below fair market value at the date of grant must be brought into compliance with section 409A by the end of the applicable transition period. This can be done by increasing the exercise price to the exercise price at the date of initial grant (or the date of adjustment), by amending the stock right so that exercise is required during the short-tem deferral period, or by bringing the option into compliance with section 409A by allowing exercise of the option only at a time permitted by the distribution rules.

The final regulations confirm that the aggregation rules apply to the correction of discounted options. Thus, if an individual exercised a discounted stock right in 2006 and the exercise violated section 409A, the value of that stock right is aggregated with all other outstanding discounted stock rights. There are ways to avoid subjecting all such rights to penalties. If the stock right is amended so that it fits the exception for stock rights (i.e., by increasing the exercise price) or the short-term deferral exception, it will no longer be deferred compensation and will not be aggregated with rights that are. Some practitioners make the argument that unexercised rights can be converted into a section 409A-compliant account balance plan, which will not be aggregated with stock rights.

Observation

The timing of any bonus or other right to compensate for the lost discount related to an increase in exercise price must comply with section 409A. For corrections made in 2007, a related bonus payment cannot be made earlier than 2008 because of the prohibition against using the transition rules to accelerate deferred compensation.

Funding Arrangements for Nonqualified Deferred Compensation

Section 409A prohibits two funding techniques for securing the payment of deferred compensation to executives — offshore rabbi trusts and plan provisions that transfer assets to a "secular" trust (not subject to the claims of creditors) if the employer is in financial distress — by providing that either arrangement results in current income and additional tax of 20 percent (or more, if increases based on interest at the underpayment rate plus 1 percent also apply).

A rabbi trust is subject to the claims of the employer-grantor's general creditors in the event of the employer's bankruptcy. Section 409A provides that a trust setting aside assets to fund deferred compensation that is located outside the United States, regardless of whether the trust is subject to the claims of the employer's creditors, results in current income equal to the amount set aside plus an additional 20 percent tax. This rule does not apply if substantially all of the services that gave rise to the deferred compensation were performed outside the United States in the jurisdiction in which the assets are held. The use of rabbi trusts in the United States is unaffected by this offshore funding provision.

Another technique that some employers have used to secure the payment of deferred compensation is to provide that assets will be placed beyond the reach of the employer's creditors if the company's financial condition deteriorated. Section 409A provides that a plan that includes a provision of this sort, or that provides for establishment of a rabbi trust in the event of a financial health event, is treated as funded, leading to immediate tax liability.

The final regulations do not provide further guidance on funding restrictions. The transition guidance provided in Notice 2006-33 continues in effect until further guidance is issued.

Income Inclusion and Reporting and Withholding Obligations

Income Inclusion

Generous transition relief made violations of section 409A unlikely in 2005. In 2006 and 2007, the remaining years in the transition period, violations are expected to occur primarily as the result of exercises of discounted options, premature distributions to specified employees following a separation from service, late deferral elections, or errors in implementing the transition rules that lead to improper accelerations or postponements.

The final regulations do not include provisions related to income inclusion on a failure. Notice 2006-100 provides initial guidance, and there is discussion of the income inclusion rules in the preamble. Announcement 2007-18, related to compliance for certain discounted options, includes provisions specific to that program. Under the principles in the preamble, an operational violation during the transition period results in income inclusion in the year of the violation. To the extent that the aggregation rules would treat additional amounts as includible in income under section 409A, those amounts are not required to be included in income until the first year after transition expires. For example, if a discounted option that is required to be corrected by December 31, 2007, is not adjusted to comply or fit within an exception, the option is treated as failing to comply with section 409A beginning January 1, 2008.

Although the income is not included until the year of actual failure, the final regulations provide that the additional tax related to interest at the underpayment rate plus 1 percent is required to be included beginning in the year of vesting, or, if later, 2005. This additional amount is calculated based on the amount deferred as of the end of the year of vesting (and each subsequent year through distribution).

Deferred compensation includible in an employee’s gross income as a result of section 409A is reported as wages on Form W-2, Box 1, and in Box 12, using Code Z. Income arising from violations by directors and independent contractors is reported on Form 1099-MISC, Box 7, and in Box 15b. Code Z is not required with respect to deferred compensation distributions that comply with section 409A.

Further guidance on the application of these rules is expected.

Reporting Requirements

Section 409A imposes reporting obligations for deferred compensation. Effective for amounts deferred after December 31, 2004, and income attributable to such amounts, service recipients are required to include information about deferrals on Forms W-2 (for employees) or 1099-MISC (for directors and independent contractors), if that form is otherwise required to be filed. Deferrals eventually will be reported using Code Y in Box 12 of Form W-2 or in Box 15a of Form 1099-MISC, but the IRS has suspended these reporting requirements until further notice. The IRS has stated that no reporting will be required for deferred compensation to which service providers had a legally binding right prior to January 1, 2005, under a plan that has not been materially modified after October 3, 2004, even if the deferrals were not vested before the end of 2004 and thus are not exempt from section 409A.

Wage Withholding

Employers are required to withhold tax on income arising from violations of section 409A as if these amounts were wages received in the year of the violation. This withholding obligation does not extend to the additional 20 percent tax or interest penalties imposed by section 409A.

SECA and FICA Tax

Amounts included in income pursuant to section 409A are generally included in self-employment income for purposes of tax under the Self-Employment Contributions Act (SECA).

The tax treatment of deferred compensation for FICA purposes is not affected by section 409A. Thus, the taxation of such amounts under section 3121(a) or 3121(v)(2), as appropriate, is not changed.

Key Considerations: Implications for Nonqualified Deferred Compensation

Over the three years since enactment, section 409A has brought significant changes to nonqualified deferred compensation. At the same time, other compensation-related requirements have been changing as well. The most notable developments are the implementation of option expense accounting and the revisions to the SEC proxy disclosure rules. The result has been a period of great scrutiny for compensation programs.

The release of the final regulations marks the beginning of the end of the transition period and the relative uncertainty under the proposed regulations. With final regulations, we now have answers to some of the questions that had been pending, such as what is required for written documents and how key exceptions such those for short-term deferral or stock rights will operate. These answers will allow some greater stability for deferred compensation.

Transition relief has also provided a window to revise compensation arrangements, both for general business purposes and to avoid the consequences of section 409A. Beginning January 1, 2008, this flexibility will be greatly reduced. Service recipients and providers will have less ability to modify plan decisions made well in advance of distributions. More importantly, failures will begin to occur, exposing individuals to the significantly higher taxes imposed under section 409A.

The controversy over discounted stock options has provided a preview of how far the effects of a section 409A failure can reach. In Announcement 2007-18, the IRS offered employers a compliance mechanism through which they can correct these failures without involving the employees. While the 2007-18 program was temporary, we can hope that future guidance will allow self-correction or similar relief, perhaps by limiting the tax consequences of promptly reported failures. These issues, as well as income inclusion and reporting, are among the key items for the next phase of section 409A.

For now, plan sponsors and service providers should take advantage of the remaining transition period to ensure that all deferred compensation arrangements are identified and restructured as necessary to comply. For the future, employers in particular will need to be aware of plans that are offered to service providers, through broad arrangements or as part of individual negotiations, and to identify elements that must be designed to comply with section 409A.

Compensation plans and decisions will continue to be driven by the need to recruit and retain the individuals that employers need to compete effectively in the marketplace. Additional diligence will be essential, however, to ensure that these goals are met without exposing service providers to the potentially harsh results of section 409A.

As a result, now is a good time for employers to evaluate their deferred compensation plan structure to determine if it is the best program for employees and the company. Rather than merely making updates to existing plans to comply with the new regulations, it may make sense to re-examine deferred compensation programs to determine their effectiveness as well as their alignment with your company's overall business strategy and objectives, taking into consideration the tax, financial statement, and cash-flow implications over the desired time horizon and talent management strategies. Deloitte Tax has developed a financial model to assist with this plan evaluation.

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