

April 18, 2007

IRS Finalizes Regulations Under Section 409A, Finally

On April 10th, the IRS issued long-awaited final regulations under Code section 409A. The regulations primarily finalize rules contained in the October 2005 proposed regulations on the scope of section 409A, as well as the rules for deferral elections and distributions under plans subject to section 409A. As expected, the regulations do not extend the transition relief for section 409A compliance. *Thus, full documentary and operational compliance is required as of December 31, 2007.*

Section 409A was added to the Code in October 2004 by the American Jobs Creation Act of 2004. The rules under section 409A potentially impact many types of arrangements in addition to nonqualified retirement plans, including severance, equity compensation and bonus arrangements. The provisions essentially impose "tax qualification" rules on nonqualified plans and impose onerous penalties on employees or other service providers if these rules are violated.

We highlight below the new guidance in the final regulations¹ under the following main headings:

- Key Transition Issues
- Scope of Section 409A
- Deferral Election Rules
- Distribution Rules

I. Key Transition Issues

A. Good Faith Compliance Period Ends December 31, 2007

Notice 2005-1 was issued in December 2004 and provided that a plan would not be treated as violating the requirements of section 409A if:

- the plan was operated in good faith compliance with the provisions of the statute and guidance issued by the IRS; and
- the plan was amended by December 31, 2005 to conform to the provisions of section 409A.

¹ 72 Fed. Reg. 19233 (Apr. 17, 2007). For summaries of previous IRS guidance under section 409A, including the October 2005 proposed regulations, please see <http://www.groom.com/library/ExecutiveCompensation.html>.

The proposed regulations issued in October 2005 extended this good faith compliance period and the deadline for amending plans to December 31, 2006. Then Notice 2006-79 was issued in October 2006 extending the good faith compliance period and the deadline for amending plans to December 31, 2007.

As expected, the final regulations do not extend the December 31, 2007 deadline and they will be effective January 1, 2008. Compliance with the proposed or final regulations is not required for good faith compliance prior to 2008. However, compliance with the proposed or final regulations will be deemed good faith compliance during this period.

B. Transition Relief Still Available During 2007

Notice 2006-79 also provided for the following transition relief that remains in place for the balance of 2007:

- Distributions under qualified plans may continue to control distributions under nonqualified plans (so called "piggyback plans").
- Employers and plan participants continue to have the ability to change the distribution provisions for amounts subject to section 409A without complying with certain 409A distribution rules within certain limits.
- Stock options and stock appreciation rights (SARs) that are subject to section 409A (e.g., discounted options) may generally be replaced with exempt options or SARs or revised to provide fixed payment terms.
 - This relief was available *only through 2006* for discounted grants made to section 16 officers and directors of public companies that were not properly accounted for (i.e., appropriate expense not recorded) on a timely basis.

Thus, employers still have time to make all of the design decisions for plans subject to section 409A.

C. More Guidance on Material Modifications Affecting Grandfathered Amounts

Amounts deferred and vested before 2005 are not subject to section 409A unless the plan under which the compensation is deferred is "materially modified" on or after October 3, 2004. Generally, a plan is materially modified if a benefit or right existing as of October 3, 2004 is enhanced or a new benefit or right is added.

Prior IRS guidance gave some examples as to changes that would or would not constitute material modifications. The final regulations provide that the following will also not result in material modifications even though they impact grandfathered amounts:

- Distributions made in compliance with a domestic relations order.

- Adding actuarially equivalent life annuity forms of payment.
- Adding a cashout feature as permitted under the regulations.
- Revising a plan provision that requires immediate cancellation of a deferral election (e.g., a 12 month suspension upon receipt of a "haircut" distribution) to apply the required cancellation beginning with the next year.
- Changes to stock rights that do not result in new grant (or additional deferral feature) treatment under the regulation rules on stock right modifications and extensions.

D. Documentary Compliance

Prior guidance made clear that some level of written documentation was required for arrangements subject to section 409A. The final regulations provide more explicit guidance on these requirements as follows:

- The written terms of an arrangement may be in one or more documents.
- At the time an amount is deferred, the plan documents must specify the amount ultimately to be paid (or a formula to calculate it) and the time and the form of payment.
- The plan documents must set forth the conditions under which deferral elections (and subsequent deferral elections) may be made.
- Plan documents must contain the six month delay rule on payment to key employees of public companies by the time an employee becomes subject to the rule.
- Plan documents need not set forth conditions under which accelerated payments permitted under section 409A will be made.
- The preamble indicates that a "section 409A savings clause" will not cure noncompliant plan documents.
- Plan documents must be brought into compliance by the end of 2007.
- Actions taken during the good faith compliance period need not be contained in the documents that are effective January 1, 2008 (i.e., a restatement addressing actions taken under IRS transition relief in 2005-2007 is not required).

II. Scope of Section 409A

Section 409A generally provides that, unless certain requirements are met, amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent that they are not subject to a substantial risk of forfeiture

and have not previously been included in income. The final regulations exclude the following from coverage under section 409A: qualified plans, a bona fide sick leave or vacation plan, a disability plan, a death benefit plan, or certain other medical reimbursement arrangements. In addition, there are other broad exemptions, for example, for grants of restricted property.

Generally, the rules under section 409A apply to amounts deferred after 2004 under a plan that provides for the "deferral of compensation." The final regulations provide that, in general, a deferral of compensation occurs if a service provider has a legally binding right during a year to compensation that is or may be payable to the service provider in a later year.

Despite this broad definition of "deferral of compensation," the final regulations provide several exemptions from coverage under section 409A for types of arrangements that otherwise provide for deferred compensation under this definition.

A. Expanded Relief For Severance Pay and Post-Employment Benefits

Prior guidance provided certain exemptions from section 409A for severance arrangements and other post-termination benefits, but the exemptions contained a number of restrictions that limited their usefulness. The final regulations generally adopt these provisions with some helpful modifications and clarifications.

- **"Good Reason" Clauses May Not Disqualify.** The proposed regulations provided exemptions under the "two times pay" exemption and under the short-term deferral exemption for certain arrangements providing for payments upon an involuntary termination of employment. Left open in these rules was whether these exemptions could apply to an arrangement also providing for payments upon a "good reason" termination.

The final regulations provide circumstances under which a separation from service for good reason may be treated as involuntary. This will allow severance arrangements that provide for payments upon such terminations to qualify for the short-term deferral exemption and two times pay exemption from coverage under section 409A. The final regulations provide both a "facts and circumstances" and a safe harbor method for treating a good reason termination as involuntary as follows:

- Under the "facts and circumstances" test, a separation may be treated as involuntary where the good reason condition requires action by the employer that results in a material negative change in the employment relationship. The purpose of the inclusion of the good reason condition cannot be to avoid application of section 409A.
- The safe harbor contains certain requirements regarding the timing of the termination in relation to the initial existence of good reason, the timing of the notice an employee is required to provide to the employer on the existence of good reason and a "cure" period for the employer, and the amount, time and form of payment to be paid as compared to a regular

involuntary termination. Moreover, the final regulations describe six specific materially adverse actions that, if taken by an employer without the employee's consent, would constitute good reason for purposes of the safe harbor.

- **Two Times Pay Exemption May Cover Portion of Severance.** The final regulations generally continue the two times pay exemption. This exemption applies to arrangements providing for payments upon an involuntary separation from service or participation in a window program that are made no later than the end of the second year following separation. Payments under the arrangement generally must be limited to the lesser of two times the employee's annual compensation or two times the Code section 401(a)(17) compensation limit (a maximum of \$450,000 for 2007).

The final regulations adopt a helpful rule under which the exemption may apply to severance payments up to the two times pay limit, even where the entire amount of severance under an arrangement exceeds the limit. Thus, if an arrangement otherwise qualifies for the exemption, only the excess over the limit will be subject to section 409A, including the six month delay on payments to a key employee. Amounts under the limit will be exempt and could be paid immediately upon separation.

- **Calculating Two Times Pay Amount.** The final regulations clarify that for purposes of the two times pay exemption, the statutory limit applicable for the year of separation applies. In addition, the regulations clarify how an employee's annual compensation is determined.
- **Other Post-Employment Benefits.** Under the proposed regulations, certain benefits provided for a "limited time" after a termination of employment (*i.e.*, by the end of the second year after the year of termination) such as business expense reimbursements, medical expenses, the provision of in-kind benefits (such as office space), moving and relocation payments, and outplacement expenses were exempt from the section 409A rules. An exemption was also provided for other *de minimis* payments or reimbursements of less than \$5,000 in the aggregate.

The final regulations clarify and modestly expand these exemptions as follows:

- A right to a benefit that is excludible from income (e.g., an arrangement to provide health coverage excludible under sections 105 and 106) will not be treated as a deferral of compensation under section 409A.
- Reimbursements may be made up to the end of the third year after the year of termination as long as the expense was incurred by the end of the second year.
- The "limited period" during which taxable reimbursements of medical expenses (*e.g.*, discriminatory programs) may be provided appears to be

limited to the period during which the employee would be entitled to COBRA coverage (18 months in the case of a regular termination).

- The amount of the de minimis exemption for "other" amounts has been increased to the limit on 401(k) contributions under section 402(g) for the year of separation (\$15,500 in 2007).
- Significantly, the final regulations describe how to structure non-exempt amounts, such as taxable reimbursements and tax-gross up payments, to comply with the distribution rules of section 409A.

Other notable issues addressed or clarified in the final regulations regarding separation pay and certain post-termination reimbursements include:

- **Rebuttable Presumption as to Involuntary or Voluntary Nature.** The final regulations clarify that whether a termination is considered "voluntary" or "involuntary" for purposes of these rules is a "facts and circumstances" test. However, any characterization of the termination by the employer and employee in the documentation relating to the termination is rebuttably presumed to properly characterize its nature.
- **Amounts Otherwise Forfeitable Paid Upon Voluntary Separation.** Where an employee would otherwise forfeit a payment subject to section 409A upon voluntary separation from service but payment is made anyway, the regulations presume that the payment results from an acceleration of vesting followed by a payment of the amount subject to section 409A. Therefore, any change in the payment schedule would be subject to the rules of section 409A (e.g., an impermissible acceleration).

B. Stock Rights: Options and SARs

The proposed regulations provided generally that "stock rights" – nonqualified stock options and stock appreciation rights ("SARs") – are exempt from coverage under section 409A provided: (1) the stock right is granted for not less than the fair market value of the underlying stock at the date of grant, (2) the stock right does not include any feature for the deferral of compensation, and (3) the number of shares covered by the grant are fixed on the grant date.

The final regulations generally adopt the provisions in the proposed regulations regarding stock rights, with certain helpful modifications and clarifications.

- **Extensions of Options.** The proposed regulations set forth detailed rules governing the types of modifications, extensions, or renewals of stock rights that will or will not result in treatment as a new grant or an additional deferral feature.

The final regulations loosen the rule in the proposed regulations that treated an extension of a stock right's exercise period as an additional deferral feature as of the date of grant of the right. Specifically, they provide that an extension generally will not be treated as an additional deferral feature if the exercise period

is not extended beyond the earlier of the original maximum term of the stock right or 10 years from the original date of grant of the stock right. Furthermore, the final regulations provide relief regarding the extension of exercise periods for "underwater" options, and provide that extensions occurring prior to April 10, 2007 are disregarded for purposes of this rule.

- **Definition of Service Recipient Stock.** The proposed regulations defined the types and classes of stock – "service recipient stock" – that exempt stock rights could cover. Under the proposed regulations, service recipient stock included only common stock tradable on an established securities market, or if there was no such stock, that class of common stock that had the greatest aggregate value.

The final regulations clarify (and expand) the definition of "service recipient stock" by adopting more flexible rules regarding both the classes of stock that may qualify as service recipient stock and the issuers whose stock may constitute service recipient stock.

- With regard to the class of stock, the final regulations generally provide that any class of common stock qualifying under Code section 305 may be used. A preference with respect to liquidation rights, without any other preferences (such as a preferential right to dividends), does not cause stock to fail to qualify as service recipient stock.
- With regard to the issuers of stock, the final regulations generally provide that service recipient stock may include the stock of the corporation for which an employee was providing services at the date of grant and any corporation above that corporation in a chain of organizations all of which have a controlling interest in another. The chain begins with the parent organization and ends with the organization for which the employee was providing services at the date of grant. The regulations contain detailed and flexible rules describing when an organization has a controlling interest in another.
- For stock rights issued before April 10, 2007 that were designated as service recipient stock under a reasonable, good faith interpretation of that term, the final regulations provide that the stock will continue to be deemed to be service recipient stock.

Other notable issues that are addressed or clarified in the final regulations regarding stock rights include:

- **Defining "Date of Grant"**. The final regulations borrow the definition for the "date of grant" of an option from the ISO regulations. Accordingly, for section 409A purposes, that phrase refers to the date when the granting corporation completes the corporate action necessary to create the legally binding right constituting the option. This is important for determining whether options may be treated as discounted and subject to section 409A.

- **Valuation – No Independent Appraisal Required.** The final regulations generally adopt the rules in the proposed regulations governing valuation of stock not readily tradable on an established securities market, which generally require that a valuation of stock be based upon a reasonable application of a reasonable valuation method. The regulations clarify that an independent appraisal is not required to meet this standard.
- **Valuation – Consistency Not Required.** The final regulations clarify that an employer may use one valuation method for purposes of establishing an exercise price and then switch to another method that is used to determine the fair market value of the stock at time of payment or the buy back amount. However, once an exercise price has been established, the exercise price may not be changed through the retroactive use of another valuation method.
- **Choice Between Equity Compensation Alternatives.** The regulations clarify that an election between compensation alternatives, none of which are subject to section 409A, will not cause the election to be subject to the section 409A election rules. For example, a choice between an award of restricted stock or exempt stock options will not be subject to section 409A. However, where any of the alternatives is subject to section 409A (e.g., a "restricted stock unit" or "RSU"), the election must comply with the provisions of section 409A.

C. **"Short-Term Deferral" Exemption**

Prior guidance provided an exemption from section 409A for arrangements that fit within a "short-term deferral" exemption. Under that exemption, a deferral of compensation does not occur under a plan if – absent an election to defer a payment to a later period – the amount is actually or constructively received by an employee by the end of the applicable 2½ month period described in the regulations.

The final regulations generally adopt the short-term deferral exemption with some modifications and clarifications.

- **Payments That May be Made After Short-Term Period Do Not Qualify.** The final regulations clarify that the short-term deferral exemption does not apply if the payment event will or may occur after the end of the applicable 2½ month period (for example, an amount that will be paid upon an employee's separation from service, which may occur many years in the future). This change makes clear that where a plan sets forth a payment date or event, that date or event must not be capable of occurring later than the end of the applicable 2½ month period. This clarification eliminates some creative arguments that were being made for use of the exemption (e.g., exercises of discounted options shortly after vesting).
- **Unforeseen Administrative Delay and "Going Concern".** The final regulations continue to carve out an exception for delays in payment beyond the applicable 2½ month period where the delay is caused by unforeseen administrative issues. In addition, the final regulations provide that payment may

be delayed beyond the applicable 2½ month period where the payment would jeopardize the ability of the employer to continue as a "going concern."

D. Foreign Plan Exemptions

The final regulations, like the proposed regulations, do not provide a blanket exclusion from section 409A for all foreign and multi-national arrangements. However, they do retain – and slightly expand upon – the exceptions in the proposed regulations, and provide new rules that apply to residents of U.S. possessions. The overall approach can be summarized as follows.

- **U.S. Citizens.** U.S. citizens are subject to taxation on their worldwide income. Therefore, all compensation (regardless of source) deferred under a nonqualified deferred compensation plan is subject to section 409A, except: (1) the unused section 911 limit (limited exclusion for foreign earned income), (2) any amount not subject to taxation as a result of a treaty, (3) nonelective deferrals of foreign earned income – defined more broadly in the final regulations -- under a broad-based foreign retirement plan (up to the section 415 limits), (4) contributions to a funded foreign arrangement subject to taxation under section 402(b), and (5) totalization and tax equalization payments, as expanded under the final regulations.
- **U.S. Residents.** Resident aliens are also subject to worldwide taxation. Therefore, all compensation (regardless of source) deferred under a nonqualified deferred compensation plan is subject to section 409A, except as generally noted above for U.S. citizens. Also, there are two special provisions for resident aliens intended to prevent undue hardship: (1) amounts previously deferred and vested while working abroad as a non-resident alien are exempt, and (2) in the year the individual becomes a resident alien, special transition relief applies.
- **Non-Resident Aliens.** Non-resident aliens are generally subject to section 409A for deferred compensation earned for services performed in the U.S. that is not otherwise exempt from Federal income taxation under the Code or an applicable treaty. However, there are two exceptions: (1) U.S. compensation/services up to the section 402(g) limit for the year (\$15,500 in 2007) (plus earnings thereon), and (2) U.S. compensation deferred under a broad-based foreign retirement plan (plus earnings thereon).

E. Split-Dollar Life Insurance

The final regulations continue to reflect the position that split-dollar arrangements may involve a promise to transfer an economic benefit in the future that provides for deferred compensation subject to section 409A. Much of the substantive guidance regarding the application of section 409A to split-dollar plans is contained in Notice 2007-34, which was also issued on April 10. The Notice addresses both how section 409A applies to split-dollar plans and whether changes to split-dollar plans to comply with or avoid section 409A may constitute a material modification which will cause the arrangement to lose treatment as a "grandfathered" split-dollar plan.

The Notice generally provides that split-dollar arrangements that provide for deferred compensation will be subject to section 409A. However, arrangements that provide only death benefits to the employee (as defined in the section 409A regulations), or that provide a legally binding right to amounts that are included in income in accordance with the short-term deferral exception, are not subject to section 409A.

The Notice provides rules for determining earnings on section 409A grandfathered amounts when there are both grandfathered and non-grandfathered benefits under the split-dollar arrangement. Generally, any reasonable method is acceptable, but it will not be reasonable to allocate a disproportionate amount of policy costs and expenses to the non-grandfathered component. The Notice also provides a safe harbor method for determining the grandfathered benefit and allocated earnings.

The Notice generally continues the proposed regulation's distinction between the "economic benefit" split-dollar regime of Treas. Reg. section 1.61-22 and the "loan regime" of Treas. Reg. section 1.7872-15. The former is generally subject to section 409A (except where the arrangement satisfies the short-term deferral rule), while the loan regime is not – unless amounts on a split-dollar loan are waived, cancelled, or forgiven. These economic benefit and loan regimes generally apply to split-dollar arrangements entered into after September 17, 2003, provided that the arrangement is not "materially modified" after September 17, 2003. However, because deferrals after 2004 could be subject to section 409A, it will often be necessary to amend such arrangements to comply with or avoid application of section 409A. The Notice provides that a modification to the arrangement will not be treated as a material modification for purposes of Treas. Reg. Section 1.61-22 if certain conditions are met.

F. Section 457(f) Plans

Section 457(f) provides generally that amounts deferred under deferred compensation plans maintained by tax-exempt or governmental employers that are ineligible under section 457(b) are includible in income when such amounts are no longer subject to a substantial risk of forfeiture. The final regulations maintain the position in the proposed regulations that section 457(f) plans may also be subject to section 409A and that section 409A applies "separately and in addition to" section 457(f). The final regulations do, however, provide additional guidance on the application of the short-term deferral exemption to section 457(f) plans. Under the final regulations, an amount is treated as paid from a section 457(f) plan for purposes of applying the short-term deferral exception when it is included in income under section 457(f) – whether or not an actual (or constructive) payment is made.

The preamble to the final regulations notes that where amounts are included in income under section 457(f) as a result of the lapse of a substantial risk of forfeiture that also is a substantial risk of forfeiture under section 409A, the amount will be excluded from section 409A under the short-term deferral exception. The preamble notes, however, that earnings on amounts that were previously included in income under section 457(f) will be subject to section 409A unless the earnings independently qualify for an exclusion.

In determining whether a section 457(f) plan could also be subject to section 409A, the critical issue will be whether the applicable vesting condition under section 457(f) would also

qualify as a substantial risk of forfeiture for purposes of section 409A. The definition of substantial risk of forfeiture in the final section 409A regulations is more restrictive than the definition under section 83 and that typically used under many section 457(f) arrangements. Notably, the final regulations retain the rules from the proposed regulations that so-called "rolling risks of forfeiture" are disregarded and that a substantial risk of forfeiture does not exist merely because an employee's right to payment is conditioned on compliance with a non-compete agreement.

G. Legal Settlements and Indemnification

The final regulations also provide exemptions from section 409A for:

- Settlements or awards resolving *bona fide* legal claims based on wrongful termination, employment discrimination, the Fair Labor Standards Act, or worker's compensation statutes, regardless of whether such settlements or awards are treated as compensation for Federal tax purposes. The carve-out also includes the payment of, or the reimbursement for, attorney's fees incurred in the connection with such claim. The claim must be bona fide and cannot act as a substitute for, or allow the restructuring of, pre-existing nonqualified deferred compensation subject to section 409A.
- The right to indemnification payments in connection with a claim for damages resulting from services by the service provider (to the extent permitted by law), and liability insurance coverage providing for payment in the event of such a claim.

H. Plan Aggregation

Prior guidance indicated that all plans of a similar type (e.g., account balance plans) would be aggregated and treated as one plan for certain purposes under section 409A. For example, if a violation occurred due to an improper distribution to an executive under a plan, the section 409A penalty provisions would apply to all amounts under that plan and all other plans of the same type in which the executive participated.

The final regulations expand the types of plans for this purpose from four to nine. The plan categories are now:

- elective account balance plans
- nonelective account balance plans (e.g., profit sharing-type plans)
- nonaccount balance plans (e.g., SERPs)
- involuntary separation pay plans
- in-kind benefits and reimbursements
- split-dollar life insurance arrangements

- foreign plans
- stock rights (options and SARs)
- other plans

This change means, for example, that a violation in a plan providing small benefits will not cause the costly section 409A penalty provisions to apply to an executive's entire SERP benefit.

III. Deferral Election Rules

Generally, an initial election to defer compensation must be made by the close of the year preceding the year in which compensation subject to the deferral election is earned. The election must include the time and form of payment and must be irrevocable as of the deadline for making the election. In the case of a nonelective deferral (e.g., as with a SERP), the plan must satisfy the latter requirements.

Section 409A provides special rules for initial deferral elections in the case of new participants and performance-based compensation. The IRS addresses these special rules in the final regulations and provides special rules for initial deferral elections in various other contexts.

A. Performance-Based Compensation

An election to defer "performance-based compensation" with a performance period of at least twelve months may be made as late as six months before the end of the period, provided the election is made before such compensation is readily ascertainable. The final regulations generally adopt the definition of performance-based compensation contained in the proposed regulations, with a few small changes and clarifications. The final regulations also clarify that provisions permitting distribution of compensation upon death, disability, or change in control without regard to whether the performance criteria are satisfied will not cause such compensation to fail to qualify as performance-based (unless such an event occurs before the deferral election is made).

B. 30-Day Rule For New Participants

Generally, an initial election to defer compensation may be made within 30 days after the date an employee first becomes eligible to participate in a plan. An employee will only be treated as a new participant in a plan if he has not previously participated in any plan of a similar type (e.g., any elective account balance plan) maintained by the employer, as determined under the expanded categories of plans in the final regulations. The final regulations also provide that the 30-day rule will be available if the employee had not been an active participant in such a plan for at least 24 months (e.g., in the case of a re-hire). In the case of a nonelective excess benefit plan, an employee may be treated as newly eligible to participate as of the first day of the year after the first year the employee accrues a benefit under the plan (and to apply the election even to benefits for services before the election).

C. Restricted Stock Units and Other Ad Hoc Grants

The proposed regulations provided that where a grant of compensation is subject to a forfeiture condition requiring the continued performance of services for a period of at least 12 months, an election may be made no later than 30 days after the date of grant, provided the election is also made at least 12 months in advance of the earliest possible vesting date. The final regulations provide that such an election may be made even if the compensation subject to the election could vest within the 12-month period due to death, disability, or a change in control, provided that, if one of these events occurs before the end of the 12-month period, the deferral election may be given effect only if it is otherwise permissible. This clarification should facilitate use of this rule for deferrals of restricted stock units and similar awards.

D. Separation Pay

The proposed regulations provided that an initial election to defer severance payable as a result of an involuntary separation from service and that is the subject of bona fide, arm's length negotiations (or payable based on participation in a window program) may be made at any time prior to the employee's obtaining a legally binding right to the payment. The final regulations expand this rule to include payments upon a voluntary separation from service.

E. Commissions

The proposed regulations provided that if an employee's right to commission compensation is contingent on a customer making a payment (e.g., to renew an insurance policy), an initial election to defer the commission compensation need only be made prior to the year in which the customer makes the payment. The final regulations provide that the year in which the sale occurs may be substituted for the year in which payment is made so long as such rule is applied consistently to all similarly situated employees. The final regulations also provide rules for deferral elections regarding investment commission compensation.

F. Other Deferral Election Rules

In general, the final regulations retain other special rules for initial deferral elections, including the following:

- An initial election to defer compensation that would otherwise fit within the short-term deferral rule exception generally is governed by the subsequent election rules, with the date on which the substantial risk of forfeiture lapses being treated as the original time of payment.
- Participant deferral elections under a 401(k) "wrap around" plan may result in increases or decreases in amounts deferred (and matching contributions) under a related nonqualified plan without violating section 409A, as long as the increases and decreases on the nonqualified side are limited to the section 402(g) deferral limit.
- An election to defer "fiscal year compensation," defined as compensation relating to a period of service coextensive with one or more consecutive taxable years of

the employer, may be made before the beginning of the first taxable year of the employer in which any of the relevant services are performed.

IV. Distribution Rules

The final regulations incorporate the statutory requirement that payments be made no earlier than a fixed date or under a fixed schedule, or upon any of five events: (1) a separation from service, (2) death, (3) disability, (4) change in control, or (5) unforeseeable emergency.

As expected, the final regulations retain a number of the general rules provided in the proposed regulations. A plan may provide for distributions upon the earlier of, or the later of, two or more specified permissible events. Any distribution made to a "specified employee" as a result of a separation from service may not be made for at least six months after the separation. Any "subsequent election" to change the time or form of a distribution generally may not take effect for 12 months and must provide for a new distribution date that is at least five years after the date the distribution would have otherwise been made. And generally, section 409A prohibits an acceleration of payment under a nonqualified deferred compensation plan subject to certain exceptions.

The final regulations include some significant clarifications to the distribution rules in section 409A as follows.

A. Objective Payment Date Required

For payment as a result of an event listed above, the plan must either state the date of the event as the payment date or designate an objectively determinable date following the event upon which the distribution is to be made or commence. A payment will continue to be treated as made on the designated distribution date if made by the later of (1) the end of the year containing the designated date, or (2) the 15th day of the third month following the designated date. Although the final regulations continue to permit this flexibility for payments after the designated date, the same flexibility generally is not provided for payments preceding the designated date within the same calendar year. The final regulations provide relief for such a payment only if it is made within the 30-day period before the designated date and the employee is not permitted to elect the taxable year of payment.

As requested by comment letters, the final regulations address the permissibility of a provision requiring payment "as soon as administratively feasible" after a payment event. This type of provision will be treated as providing for a specified payment date only if the potential payment period is expressly restricted to one taxable year or is no longer than 90 days and the employee is not permitted to elect the taxable year of payment. The first possible date for payment in such period will be used as the specified payment date for purposes of applying the subsequent deferral election rules. For example, a plan provision for payment as soon as administratively feasible within 90 days of a separation from service generally will be treated as providing for a specified payment date, and the date of the separation from service will be used for subsequent deferral purposes.

B. Multiple Payment Events Permitted

The final regulations continue to permit a plan to provide for different forms of distribution depending on the actual triggering event. Likewise, a plan may allow for an alternate distribution schedule if a specific triggering event occurs before or after a specified date. For example, a plan may provide that an employee will receive a lump sum payment upon a change in control if it occurs before the employee attains age 55, but will receive a life annuity upon a change in control if it occurs on or after the employee attains age 55.

In addition, the final regulations permit alternative distribution schedules based on different types of separation from service. A different time and form of payment may be designated for each of the following:

- a separation from service within the two-year period following a change in control as defined under section 409A;
- a separation from service before or after a specified date or a combination of a specified date and a specified service period (e.g., age 50 and 10 years of service under a qualified plan); and
- a separation from service other than as described above.

Any addition or deletion of a different distribution schedule applicable to an existing deferral is subject to the subsequent deferral election rules and the anti-acceleration rules discussed below.

C. Certain Delayed Distributions Allowed

Generally, the final regulations provide that if making a scheduled payment under a plan would jeopardize the employer's ability to continue as a going concern, the payment may be delayed until the first taxable year in which the payment would not have such effect. In addition, the final regulations permit the delay of a scheduled payment due to the operation of a fixed or objective formula limitation provided certain requirements are satisfied. For example, the payments during any given year may be limited to a certain percentage of cash flow.

The rules continue to give the employer the ability to delay distributions if (1) the deduction associated with the distribution would be limited by section 162(m), or (2) the distribution would violate securities or other applicable laws. Lastly, the final regulations confirm the relief provided for delayed payments due to an employer's refusal to pay benefits (both intentional and inadvertent) provided the employee makes prompt, reasonable, good faith efforts to collect the payment.

D. Distributions on "Separation From Service"

Distributions may be made under section 409A when a participant "separates from service." The final regulations provide considerable guidance on when a service provider – whether an employee or independent contractor -- will be treated as separating from service for purposes of section 409A. The final regulations articulate a general standard for determining whether, based on the facts and circumstances, the parties reasonably anticipated at the time of

the separation from service that no further services would be performed or that the level of an employee's services would permanently decrease to 20 percent or less of his average service level (generally determined over the preceding 3-year period). In addition, the final regulations include rebuttable presumptions under which an employee is presumed to separate from service if the level of services performed actually decreases to 20 percent or less of his average service level (again generally determined over the preceding 3-year period). Conversely, an employee is presumed not to separate from service if the level of services actually performed continues at a rate that is 50 percent or more of his average service level.

These presumptions are rebuttable by demonstrating that the employer and employee reasonably anticipated that the level of services would be reduced permanently below the 20 percent level, or that the level of services would not be so reduced, as applicable. For example, a change in business circumstances such as the termination of an employee's replacement or the loss of a business client of the employer may result in the former employee's return to work or the unforeseen reduction in an employee's services, respectively. The final regulations provide additional flexibility for a plan, prior to setting the payment schedule, to expressly define separation from service as including a specified reduction in level of services between 20 percent and 50 percent.

The final regulations provide generally that the definition of "service recipient" for purposes of the separation from service rules is determined on a controlled group basis under the rules in sections 414(b) and (c), with a 50 percent ownership level substituted for 80 percent. A plan may specify another ownership level of between 20 and 80 percent, provided that an ownership level of less than 50 percent may be used only if based on legitimate business criteria. The final regulations also provide rules under which, in the case of the sale of assets to an unrelated buyer, the seller and buyer may specify whether employees who go to work for the buyer after the sale have experienced a separation from service for purposes of section 409A. In addition, the final regulations address the application of these rules to employees who also serve on the company's board of directors.

E. "Key Employee" Rules

Generally, distributions made to a "specified employee" as a result of a separation from service may not be made for at least six months after the separation. The term "specified employee" generally means a "key employee" (as defined in Code section 416(i)) of a publicly-traded company on any U.S. or foreign exchange.

The final regulations provide certain default definitions and rules for purposes of identifying key employees and implementing the 6-month delay rule. For example, a plan may provide that payments to all participants upon separation from service will commence six months after such date. Alternatively, the final regulations confirm that the use of an alternative method that results in an over-inclusive list of key employees (no more than 200) will not violate section 409A even if an employee is not a specified employee when the payment is delayed.

Another default rule provides that the first day of the fourth month following the key employee identification date will be the effective date for a new list of specified employees. However, the final regulations permit an employer to specify an earlier date following the

identification date upon which the new list of specified employees will become effective. For example, if the identification date for determining key employees is December 31, an employer may specify any subsequent date on or before April 1 (e.g., January 1) as the first date of the 12-month period during which such list of key employees will be treated as specified employees and subject to the 6-month delay rule. The final regulations also provide additional guidance for determining key employees after a corporate transaction, such as a merger or spin-off, including that no more than a total of 50 employees of the post-transaction entity/entities are required to be treated as specified employees.

F. "Subsequent Election" Rules

The final regulations clarify that the rules governing changes in time and form of payment apply to changes made by both employers and employees. Generally, these "subsequent elections" may not take effect for 12 months and must provide for a new distribution date that is at least five years after the date the distribution would have otherwise been made.

The final regulations confirm the substantial flexibility provided in the proposed regulations with respect to "subsequent elections." The rules are complex and will call for changes in most plans subject to section 409A.

G. Choices Among Life Annuities

The final regulations provide helpful clarifications and increased flexibility regarding the exception to the subsequent election rules for a choice between actuarially equivalent life annuity options. Generally, a change from one life annuity form to another actuarially equivalent life annuity form before any payments have been made will not be considered a change in the time or form of payment, and therefore will not be subject to the subsequent election rules. The final regulations expand this rule by excluding the following features from the determination of whether an annuity qualifies as a "life annuity":

- term certain features,
- pop-up provisions,
- cash refund features,
- Social Security or Railroad Retirement leveling features, and
- permissible cost-of-living adjustment features.

However, these features are not disregarded in determining whether life annuities are actuarially equivalent. In addition, the final regulations provide that a subsidized joint and survivor annuity is treated as actuarially equivalent to a single life annuity, provided that neither the annual lifetime annuity benefit nor the annual survivor benefit under joint and survivor annuity is greater than the annual lifetime annuity benefit under the single life annuity.

H. Prohibition on Accelerated Distributions

Generally, section 409A prohibits an acceleration of a scheduled payment under a nonqualified deferred compensation plan. The proposed regulations and Notice 2005-1 enumerated several exceptions to this rule. The final regulations provide the following additional clarification and guidance:

- **Substitute Payments.** The payment of an amount as a substitute for a payment of deferred compensation will be treated as a payment of the deferred compensation, including for purposes of the prohibition on accelerated payments (e.g., receipt of a loan secured by an offset to a nonqualified deferred compensation benefit or payment of current bonus proximate to the forfeiture of a right to deferred compensation).
- **Employer Discretion Permitted.** The final regulations clarify that an employee may not have discretion (*i.e.*, through the provision of an election) to determine whether a payment will be accelerated under an exception permitting the acceleration of payments. However, a plan may provide the employer with discretion to accelerate a payment under an exception, and the failure to accelerate such payment will not constitute a subsequent deferral election.
- **Settlement of Bona Fide Dispute.** Payments may be accelerated (e.g., payment as a lump sum) where the right to payment arises pursuant to the settlement of a bona fide dispute over an employee's right to deferred compensation.
- **Cancellation Due to Disability.** The final regulations permit the cancellation of an employee's deferral election due to the employee's disability, provided that the disability satisfies certain requirements.
- **Addition of Certain Payment Events.** The addition of death, disability, or an unforeseeable emergency, as a potentially earlier (not later) alternative payment event to an amount previously deferred will not be treated as an accelerated payment, even if such addition results in the payment being paid earlier than such payment would have otherwise been made.
- **Conflict of Interest and Ethics Rules.** The final regulations clarify that an accelerated payment may be made where reasonably necessary to avoid the violation of a Federal, state, local, or foreign conflict of interest or ethics law, or where necessary for an employee in the executive branch to comply with an ethics agreement with the Federal government.
- **Failure of the ERISA Select Group Requirement.** The final regulations do not permit accelerated payments to employees who do not satisfy the "select group" requirement under the ERISA "top hat" plan exception.

I. Distributions on Plan Termination

The final regulations permit an employer to terminate a plan and distribute benefits without violating the prohibition on acceleration of payments in limited circumstances. First, an employer may exercise its discretion to terminate a plan and distribute benefits if:

- the termination does not occur proximate to a downturn in the financial health of the employer;
- all plans of the same type maintained by the employer (e.g., all elective account balance plans) are terminated with respect to all participants;
- no payments are made within 12 months of the plan termination (other than those that would have been paid absent the termination);
- all payments are made within 24 months of the plan termination; and
- the employer does not adopt a plan of the same type (e.g., a new elective account balance plan) for a period of three years (down from five years in the proposed regulations) following the date of plan termination.

Second, a plan may be terminated in connection with a change in control, corporate liquidation, or with the approval of a bankruptcy court. The final regulations clarify the rules applicable to these plan terminations and leave open the possibility that the IRS could prescribe other events and conditions that would permit a plan termination.

J. Other Miscellaneous Distribution Rules

The final regulations provide some generally applicable clarifications and guidance with respect to the distribution rules:

- **No Suspension of Payments.** Any suspension of the payments of deferred compensation following the rehire of an employee will violate the rules governing time and form of payment because payments would be delayed other than as permitted under the subsequent deferral election rules.
- **Beneficiaries Subject to Same Rules.** Elections with respect to the time and form of payment by a beneficiary are subject to the general rules governing subsequent deferrals and accelerated payments.
- **Domestic Relations Orders.** Amounts payable to an alternate payee under a domestic relations order are not subject to the rules governing subsequent deferrals, accelerated payments, or the 6-month delay.
- **Permitted Sources for Relieving Unforeseeable Emergency.** The following sources need not be considered in determining whether an unforeseeable emergency may be relieved through other means: (1) other nonqualified deferred

compensation (including "grandfathered amounts") and (2) any amounts available under a qualified plan (e.g., loans or hardship distributions).

V. Additional Guidance Expected

As expected, the regulations focus on guidance employers need to amend their nonqualified plan documents and modify their operations accordingly. Thus, the IRS did not address the funding restrictions, the Form W-2 reporting requirements, or penalty provisions under section 409A. Presumably, the IRS will be turning its attention to guidance on these issues now.

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