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# 409A PROPOSED REGULATIONS: MORE GUIDANCE AND LIMITED TRANSITION RELIEF

by
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*"The proposed regulations generally extend the plan amendment deadline to December 31, 2006, and extend some, but not all, of the other transition deadlines."*

Well, it's here. The eagerly awaited second set of guidance from the IRS on the new nonqualified deferred compensation rules (known as the "Section 409A" or "409A" rules) has arrived in the form of proposed regulations. Many open issues have been addressed, such as the application of the new rules to severance pay (mostly good news for involuntary severance) and the permissibility of 401(k) wrap plans (generally permissible, if strict benefit limitations are observed).

The initial IRS guidance on the 409A rules, which was set forth in Notice 2005-1, established December 31, 2005, as the deadline for amending nonqualified plans to comply with the new rules and pegged other transition relief to this date. The proposed regulations generally extend the plan amendment deadline to December 31, 2006, and extend some, *but not all*, of the other transition deadlines to December 31, 2006. There are several important deadlines which were not extended. Importantly, the rules for initial deferral elections, which govern the deadline by which an employee (or other service provider) must make any voluntary election to defer compensation, have not been extended. This means that even though plans need not be amended to comply with the new rules until December 31, 2006, they must currently be operated in compliance with the new initial deferral election rules, which we will describe later in this newsletter.

In addition, the proposed regulations do not extend the deadline for permitting employees to cancel outstanding deferral elections or terminate participation in a plan. An employer wishing to offer employees the opportunity to terminate plan participation or cancel an outstanding deferral election relating to amounts subject to Section 409A must amend its plan by December 31, 2005, to reflect this option. The amount subject to termination or cancellation must then be included in employees' income in 2005 or, if later, the year in which the amounts become earned and vested.

In this newsletter we will discuss five major topics addressed by the proposed regulations. We will then describe some of the steps employers need to take in response to the 409A rules, including some steps employers will need to take very soon. Readers may also wish to consult our earlier newsletter on the Section 409A rules, dated February 19, 2005. The five topics are:

- What deferred compensation is subject to the new rules?
- What are the initial deferral election requirements?
- What rules govern the time and form of payment under deferred compensation programs?
- What rules apply to wrap 401(k) plans and other plans linked to qualified plans?
- What effective date and transaction rules apply?

## What Deferred Compensation is Subject to the New Rules?

**Nonqualified Deferred Compensation Plans**. The new Section 409A rules apply to amounts deferred under "nonqualified deferred compensation plans" – that is, plans that provide for the deferral of compensation. Some programs are, however, excused from application of the rules. In particular, Section 409A does not apply to Section 401(k) or other qualified retirement plans, Section 403(b) tax-sheltered annuities, simplified employee pensions (SEPs), or simple retirement accounts (SIMPLEs). In addition, the Section 409A rules do not apply to certain welfare benefit plans, including bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans. Although the 409A rules do not apply to Section 457(b) eligible deferred compensation plans maintained by tax-exempt or governmental employers, they do apply to Section 457(f) plans maintained by those same employers.

**Independent Contractors**. The 409A rules apply not only to the deferral of compensation by employees, but also to deferred compensation arrangements with other service providers, such as independent contractors. Under the proposed regulations, amounts deferred with respect to a service provider that uses an accrual method of accounting will not be subject to Section 409A. An accrual basis service provider will normally already be taking into income compensation as it is earned, absent some structured payment arrangement. This exception for accrual basis taxpayers will not benefit employees, since they are generally cash basis taxpayers.

In addition, the 409A rules generally do not apply to independent contractors providing significant services to at least two service recipients, if those service recipients are unrelated to one another and unrelated to the independent contractor. In determining whether services are significant for this purpose, the proposed regulations would make this determination separately for each trade or business in which the independent contractor is engaged. For example, an independent contractor providing computer programming services for one company would not be exempt from the 409A rules simply because, as a separate trade or business, the independent contractor paints houses for another party. The proposed regulations offer a safe harbor under which an independent contractor providing services to multiple service recipients that are unrelated to one another, and to whom the independent contractor is not related, will be treated as providing significant services to more than one service recipient. Under this safe harbor, an independent contractor will be treated as providing significant services to more than one service recipient, and therefore exempt from the 409A rules, if not more than 70 percent of the total revenue generated by the trade or business in the taxable year is derived from any one service recipient (or any single group of related service recipients). This exception does not apply where

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"A legally binding right to compensation may exist even where the right is subject to a condition. . .."

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the services provided by the independent contractor are management services. For this purpose, management services include services involving actual or de facto direction or control of the financial or operational aspects of the service recipient's trade or business, or investment advisory services that are integral to the trade or business of a service recipient whose primary trade or business involves the management of investments in entities other than the entities comprising the service recipient, such as a hedge fund or real estate investment trust.

**Directors**. Although an independent contractor generally may avoid application of Section 409A by providing services to more than one unrelated service recipient, this exception does not apply to outside (that is, non-employee) directors. In other words, an individual will not be exempt from the 409A rules merely because he or she serves as a director for two or more unrelated organizations. The proposed regulations do, however, offer outside directors some relief from the plan aggregation rules (which are described more fully later). In particular, where payments to an outside director violate the 409A rules, this violation will not cause the director to be taxed on his or her directors' fees from an unrelated company.

Consistent with treating directors' fees paid by separate companies separately, where a director terminates services with one company, but remains on the board of directors of an unrelated company, payments may be made to the director upon separation from service under the first company's plan despite his or her continued service as a director of the unrelated company.

As to employee-directors (that is, inside directors), the 409A rules apply separately to the employee's services as a director and his or her services as an employee, so long as some outside director defers compensation under the same, or a substantially similar, arrangement on similar terms.

**Deferral of Compensation**. Under the proposed regulations, a plan will provide for the deferral of compensation, and therefore be subject to the 409A rules, only if, under the terms of the plan and the relevant facts and circumstances, (a) the employee or other service provider has a **legally binding right** during a year to compensation that has not been actually or constructively received and included in income, and (b) pursuant to the terms of the plan, that compensation is **payable** to (or on behalf of) the employee (or other service provider) **in a later year**. A legally binding right to compensation may exist even where the right is subject to a condition, including a condition that constitute a substantial risk of forfeiture. For example, an employee who in Year One is promised a bonus equal to a set percentage of employer profits, to be paid out in Year Three if the employee remains employed through Year Three, is considered to have a legally binding right to the payment of the compensation, subject to the conditions being met. This promise constitutes a legally binding right even though the employee is not yet vested.

An employer does not, however, have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated by the employer (or by another person) after the services creating the right to the compensation have been performed. If the facts and circumstances indicate that (a) this discretion to reduce or eliminate compensation is available or exercisable only upon a condition, or (b) the discretion to reduce or eliminate the compensation lacks substantive significance, the employee (or other service provider) will nevertheless be considered to have a legally binding right to the compensation. In addition, where the employee has effective control over, or is related to, the person granted the discretion to reduce or eliminate the compensation, or has effective control over all or any portion of that person's compensation or benefits, the discretion will be ignored and the employee will be treated as having a legally binding right to the compensation.

*"In a very important exception, the 409A rules do not apply to short-term deferrals."*

**<u>Short-Term Deferrals</u>**. In a very important exception, the 409A rules do not apply to short-term deferrals. A short-term deferral occurs if the terms of a plan at all times require payment by the later of (a) 2-1/2 months from the end of the *calendar year* in which the amount is no longer subject to a substantial risk of forfeiture, or (b) 2-1/2 months from the end of the *employer's taxable year* in which the amount is no longer subject to a substantial risk of forfeiture. For an amount that is not subject to a substantial risk of forfeiture, but is instead immediately vested, the amount is considered no longer subject to a substantial risk of forfeiture on the date the employee first has a legally binding right to the amount.

This short-term deferral exception is especially important because for amounts that are subject to vesting requirements, or are otherwise subject to a substantial risk of forfeiture, the 2-1/2 months is measured from the year in which the employee vests (or is no longer subject to a substantial risk of forfeiture), not from the first year in which the employee provides services. As a result, multi-year bonus arrangements that require payment promptly after the bonus amounts vest will normally not be subject to the 409A rules.

The proposed regulations would even permit use of this short-term deferral exception where a plan document does not by its terms require payment within the 2-1/2 month period. A plan intending to rely on the short-term deferral exception would, however, nevertheless enjoy an advantage by including the 2-1/2 month rule in the plan's terms. That is because the proposed regulations would then permit the plan to enjoy the short-term deferral exception even in some circumstances where the payment deadline is missed. In contrast, where an arrangement does not provide in writing that a payment must be made by a specified date on or before the 2-1/2 month deadline, and payment is not made by that deadline (and the delay is not due to unforeseeable administrative or solvency issues, as noted below), the payment will result in automatic violation of Section 409A because of the failure to specify the payment date or a permissible payment event. In addition, certain rules (described later), which give an employer limited discretion to delay payments of amounts subject to Section 409A would be unavailable.

Where an arrangement provides in writing that a payment must be made by a specified date on or before the 2-1/2 month deadline, and the payment is not made by the appropriate deadline so that the 409A rules become applicable, the proposed regulations would generally permit payment to be made in the same calendar year as the fixed payment date. In addition, rules permitting a plan to provide for a delay in payment in certain circumstances, as well as relief applicable to disputed payments and refusals to pay (both of which are described later in this newsletter), are available where a plan by its written terms requires that payment be made by a specified date within the 2-1/2 month deadline. As a result, it will often be advantageous to include in a plan a date or year for payment, even where it is intended that payment be made within the short-term deferral period.

The proposed regulations would extend the 2-1/2 month deadline where timely payments are not administratively practicable. In particular, a payment made after the 2-1/2 month deadline can continue to be treated as meeting the short-term deferral exception if (a) it was impracticable, either administratively or economically, to avoid the late payment, (b) as of the time the legally binding right to the compensation arose, this impracticability was unforeseeable, and (c) payment is made as soon as practicable. This relief appears to be available to short-term deferrals even where the plan by its written terms does not require payment by a specified date within the 2-1/2 month short-term deferral period. Although the IRS had been asked to add an exception for delays resulting from unintentional error, the Service refused to do so.

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*"The proposed regulations would provide substantial relief for severance plans. . .."*

Under the proposed regulations, the vesting of substantially nonvested property subject to the Section 83 restricted property rules may be treated as a payment for purposes of Section 409A, including for purposes of applying the short-term deferral rule. Restricted property for this purpose generally includes restricted stock, but would not include an unfunded and unsecured promise to pay money or other property. As a consequence, the short-term deferral rule may have surprisingly broad application, such as in the following example where an employee is offered a choice between a cash bonus and substantially nonvested property that is potentially more valuable than the cash amount. In this example, an employee participates in a two-year bonus program under which, if the employee continues in employment for two years, he or she is entitled to either an immediate payment of a $10,000 cash bonus or the grant of restricted stock with a $15,000 fair market value subject to a vesting requirement of three additional years of service. This arrangement generally will constitute a short-term deferral which avoids application of Section 409A. That is because under either alternative the payment would be received within the short-term deferral period (that is, under the 2-1/2 month rule), since the employee will be treated as being paid the restricted stock as soon as it vests.

**Separation Pay**. Many had feared the Section 409A rules would apply to many, or even most, severance pay programs. The proposed regulations would provide substantial relief for severance plans, which the regulations refer to as "separation pay arrangements." The IRS observes in the preamble to the proposed regulations that employers may, in separation pay arrangements, reserve the right to eliminate at any time severance amounts payable upon voluntary termination. Where an employer reserves this right, as it typically will, an employee may have no legally binding right to a payment until the payment actually occurs, or until such other time as the employer's discretion to eliminate the payment lapses. Severance payments will in that circumstance generally constitute short-term deferrals not subject to Section 409A. Where, however, this "negative discretion" of the employer to eliminate or deny severance pay lacks substantive significance, or the person granted the discretion is controlled by, or related to, the employee to whom the payment will be made, the employee will be considered to have a legally binding right to the compensation.

**Individually Negotiated Severance Agreements**. With respect to severance payments made upon *involuntary* termination, the IRS noted that many such severance arrangements cover multiple employees and apply to covered employees from the date they begin work. Where, instead, a separation pay arrangement is negotiated with a particular employee at the time of the employee's involuntary separation from service, the IRS was asked by commentators how the employee could make a timely initial deferral election. In particular, the 409A rule (described later in this newsletter) permitting an initial deferral election to be made within 30 days of initial eligibility applies only with respect to services performed after the election. Separation pay would, in contrast, relate primarily to services already provided. The proposed regulations, therefore, would make available a special rule that applies where separation pay due to an involuntary termination has been the subject of bona fide, arms-length negotiations between an employer and employee. In that event, the employee's election as to the time and form of payment may be made on or before the date the employee obtains a legally binding right to the payment.

**Involuntary Terminations**. The proposed regulations, quite helpfully, would also provide a much broader exception for separation pay arrangements providing payment upon involuntary separation. Under this exception, if payments upon involuntary separation do not exceed (a) two times the employee's annual compensation, or (b) if less, two times the annual dollar limit on compensation under qualified retirement plans ($210,000 for calendar year 2005), with each of these figures determined as of the calendar year before the year in which the employee separates from service, and if the arrangement

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requires that all payments be made no later than the end of the second calendar year following the year in which the employee terminates service, Section 409A would not apply. These dollar and time limitations are akin to the limits set forth in Department of Labor regulations establishing a safe harbor under which severance programs subject to ERISA will be welfare plans, rather than pension plans, and thereby avoid application of ERISA's vesting and funding requirements.

**Substituting Separation Pay for Deferred Compensation**. To avoid abuse, the exclusions from the 409A rules described above for certain separation pay arrangements would not apply to the extent separation pay acts as a substitute for, or replacement of, amounts that would otherwise be subject to Section 409A. Where, for example, a right to separation pay is obtained in exchange for an employee giving up a right to a payment of deferred compensation that is subject to the 409A rules, that separation pay would not be excluded from coverage under 409A, but would instead be treated as a payment of the original amount of deferred compensation.

**Window Programs**. The proposed regulations would also offer relief for payments under early retirement window programs, allowing them to enjoy the same exceptions that apply to involuntary separation pay plans.

**Short-term Deferral Rule and Separation Pay on Involuntary Termination**. Even where separation payments made upon an involuntary termination of services do not qualify for one of the exceptions from Section 409A described above, an employee's right to a separation payment will be considered a nonvested right if the amount is payable only upon involuntary termination. As a result, an involuntary separation pay arrangement may be structured to meet the requirements of the short-term deferral exception, and thereby avoid the application of Section 409A.

**Voluntary Termination for Good Reason**. Despite a request from commentators, the IRS refused to treat a right to payment upon voluntary termination of services for "good reason" as constituting a right subject to a substantial risk of forfeiture.

**Separation Pay Aggregation Rules**. When things go wrong, and the 409A rules are violated, all amounts deferred under plans of the same type are subject to adverse tax treatment. In Notice 2005-1, the IRS had indicated that, for this purpose, there are three types of plans: account balance plans, nonaccount balance plans, and other types of plans (generally, equity-based compensation). In the proposed regulations, the IRS added a fourth category, for separation pay due to an involuntary separation from service or participation in an early retirement window program.

**Expense Reimbursements**. Finally with respect to payments associated with the termination of services, the proposed regulations address the application of Section 409A to payments that constitute reimbursement of a terminated employee's expenses. In general, because the promise to reimburse a former employee will not be contingent on the employee's provision of any substantial services, the right to reimbursement generally will not be treated as being subject to a substantial risk of forfeiture. As a result, if the period in which incurred expenses will be reimbursed extends beyond the year in which the legally binding right arises, the right to that reimbursement generally would constitute deferred compensation. Although the IRS refused to grant a categorical exclusion from the application of Section 409A to reimbursement arrangements the proposed regulations would exempt certain reimbursement arrangements to the extent they cover only expenses incurred and reimbursed before the end of the second calendar year following the calendar year in which the employee terminates.

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The types of reimbursements that would be excluded include reimbursements that are otherwise not taxable to the employee, reimbursements for expenses that the employer can deduct as ordinary business expenses, outplacement expenses, moving expenses, medical expenses, and any other types of payments that do not exceed $5,000 in the aggregate during any given year. Reimbursement arrangements subject to this special relief also include an employer's provision of in-kind benefits, or direct payments to a person providing goods or services to a terminated employee, if the provision of those in-kind benefits or direct payments would be treated as reimbursement arrangements if the employee had paid for such in-kind benefits, or such goods and services, and received reimbursement from the employer.

**Stock Options and Stock Appreciation Rights**. In general, Section 409A does not apply to grants of incentive stock options ("ISO") nor to employee stock purchase plans (absent a modification, extension, or renewal that is treated as a grant of a new option). Nondiscounted nonqualified stock options and stock appreciation rights also would not be subject to Section 409A. That is, grants of stock options where the exercise price can never be less than the fair market value of the underlying stock at the date of grant (a nondiscounted option) would not be subject to the new rules. Conversely, an option with an exercise price that is or may be below the fair market value of the underlying stock at the date of grant (a discounted option) is subject to the requirements of Section 409A, except where the terms of the option only permit exercise during a short-term deferral period (the 2-1/2 month period described earlier).

*"[A]n option with an exercise price that is . . . below the fair market value of the underlying stock at the date of grant (a discounted option) is subject to the requirements of Section 409A. . .."*

The proposed regulations would treat stock appreciation rights ("SARs") in a fashion similar to stock options. Unlike the harsher rule for SARs set forth in Notice 2005-1, the proposed regulations would treat SARs in the same fashion as stock options whether the SARs are settled in cash and whether or not the stock on which the SARs are based is readily tradable on an established securities market. The proposed regulations refer to stock options and stock appreciation rights collectively as "stock rights."

The exception from the 409A rules for nondiscounted nonstatutory stock options is generally intended to cover only options granted on stock of the employer that is the service recipient. The proposed regulations provide guidance on when stock rights can, without losing their 409A exemption, nevertheless be based on (a) stock of a related company (generally, applying the Tax Code's control group rules using a 50 percent, rather than 80 percent, ownership standard), (b) stock of a company with an ownership interest in a joint venture, when compensating employees of the joint venture (generally permissible where the owning company has at least a 20 percent ownership interest, subject to certain special rules), and (c) stock of different classes (generally, only common stock that is readily tradable on an established market or, if there is none, the most valuable class of common stock, may be used).

The proposed regulations also offer guidance on how to value stock for purposes of determining whether stock rights are discounted and therefore subject to the 409A rules. The proposed regulations generally permit the use of an average price determined over a specified period of time for publicly traded stock, where that specified period occurs within the 30 days before and 30 days after the grant date. The regulations also provide guidance on valuing stock that is not readily tradable on an established securities market. In addition, the regulations address the conditions under which a modification, extension, or renewal of a stock right will be treated as a new grant. This is important because if a modification of a stock right is considered a new grant, the determination of whether it is discounted and therefore subject to the 409A rules will be made by looking to the fair market value of the underlying stock on the date of the new grant.

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"[I]f the 409A requirements are violated . . . under one plan, all amounts deferred by the individual under the same type of plan are aggregated and the employee is subject to adverse tax consequences on the aggregated amount."

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**Plan Aggregation Rules**. The provisions of Section 409A are applied on an individual participant basis. As a result, where the requirements of 409A are violated with respect to a participant, that individual suffers adverse tax consequences, but the violation does not disqualify the arrangement as to other participants. As noted above, however, Notice 2005-1 announced a rule under which if the 409A requirements are violated with respect to an individual under one plan, all amounts deferred by the individual under the same type of plan are aggregated and the employee is subject to adverse tax consequences on the aggregated amount. The proposed regulations establish four types of plans for purposes of these aggregation rules. The four types are: account balance plans, nonaccount balance plans, other types of plans (generally equity-based compensation), and certain separation pay plans (generally, involuntary termination and window programs).

Although a violation of the 409A requirements with respect to an individual generally does not affect other employees, the proposed regulations would create an exception for repeated violations. In particular, where a violation of a 409A requirement is not an isolated incident, or involves a number of a participants or an identifiable subgroup of participants, the violation may result in a finding that even with respect to participants who did not directly benefit from the violation, the actual terms of the arrangement differ from its written terms. For example, if a plan document provides for installment payments upon a separation from service, but participants in the arrangement repeatedly are offered the opportunity to receive a lump sum payment, the facts and circumstances may indicate that the arrangement in fact provides for an election of a lump sum payment for all participants.

**Written Plan Requirement**. The proposed regulations establish a requirement that deferred compensation arrangements subject to Section 409A be set forth in writing.

**Substantial Risk of Forfeiture**. As noted earlier, in the discussions of what constitutes deferred compensation subject to the new rules and how the short-term deferral rules apply, the determination of what constitutes a "substantial risk of forfeiture" is critical. Compensation is subject to a substantial risk of forfeiture for purposes of 409A if entitlement to the amount is conditioned on (a) the performance of substantial future services, or (b) the occurrence of a condition related to a purpose of the compensation, and in either case the possibility of forfeiture is substantial. A typical substantial risk of forfeiture occurs where an employee is required to remain in employment for a particular number of years, or to a particular date, to become entitled to compensation. This requirement causes the compensation to be conditioned on the performance of substantial future services, and therefore constitutes a substantial risk of forfeiture. As to the occurrence of a "condition related to a purpose of the compensation," the condition must relate to the employee's performance for the employer, or the employer's business activities or organizational goals. An example of the latter would be the attainment of a prescribed level of earnings, equity value, or an initial public offering.

Certain plan amendments that extend a substantial risk of forfeiture will not be recognized. In particular, so called "rolling risks of forfeiture," under which an employer or employee may periodically extend, or roll, the risk of forfeiture, will be disregarded in determining whether an employee's compensation is subject to a substantial risk of forfeiture. Noncompete agreements also will generally be ignored. That is, an amount will not be considered subject to a substantial risk of forfeiture merely because the employee's right to that amount is conditioned on the employee refraining from the performance of services (as, for example, agreeing not to compete with the employer).

*"[C]ompensation for services performed during a calendar may be deferred . . . only if the employee's election to defer is made no later than the close of the prior calendar year."*

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An amount will not be considered subject to a substantial risk of forfeiture beyond the date or time at which the employee otherwise could have elected to receive the amount. There is an exception to this rule where the amount that is subject to a substantial risk of forfeiture (ignoring earnings) is materially greater than the amount that the employee could otherwise have elected to receive. So for example, a salary deferral generally may not be made subject to a substantial risk of forfeiture. But where a bonus arrangement provides an election between a cash payment of a certain amount or restricted stock units with a materially greater value that will be forfeited absent continued services for a period of years, the right to the restricted stock units will generally be treated as subject to a substantial risk of forfeiture.

## What are the Initial Deferral Election Requirements?

In general, plans subject to Section 409A must require employees to comply with specific deadlines for making deferral elections. In particular, a plan must provide that compensation for services performed during a calendar may be deferred at the election of an employee only if the employee's election to defer is made no later than the close of the prior calendar year. This timing rule applies not only to an employee's election concerning whether and how much to defer, but also any election offered the employee as to the time and form of payment.

An election is treated, for these purposes, as being made as of the date the election becomes irrevocable. So, although changes may be made to an initial deferral election, the election must become irrevocable no later than the last permissible date for making the election (generally, by December 31 of the year prior to the year in which the services are provided to which the compensation relates). Evergreen elections, under which a deferral election as to future compensation remains in place unless the employee changes the election, are permissible under Section 409A. An evergreen election must, however, become irrevocable with respect to future compensation no later than the last permissible date for making an affirmative initial deferral election. So, for example, in the case of a salary deferral program under which an employee makes an initial election to defer ten percent of his or her salary earned during the subsequent calendar year, the plan may provide that this deferral election will remain in effect unless and until changed by the employee, so long as the election becomes irrevocable with respect to salary earned during any future calendar year by December 31 of the preceding calendar year.

**Nonelective Arrangements**. The statute is not clear concerning the election rules that apply to nonelective deferred compensation. The proposed regulations would clarify that where an employee has no choice whatsoever as to the amount deferred, or the time or form of payment, there is no "election" which must be made by the December 31 preceding the employee's provision of services. In this circumstance, the plan must, no later than the time the employee first has a legally binding right to the compensation, specify the time and form of payment.

**Performance-Based Compensation**. An exception to the general rule requiring that deferral elections be made by the prior December 31 applies to "performance-based" compensation, where that compensation is based on services performed over a period of at least 12 months. With respect to performance-based compensation, an employee's initial deferral election may be made as late as six months before the end of the performance period. This extended deadline will normally apply in the context of bonus plans.

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Under the proposed regulations, to enjoy the special election deadline, performance-based compensation must be contingent on the satisfaction of preestablished organizational or individual performance criteria. Performance-based compensation does not include any amount, or portion of amount, that would be paid (a) either regardless of performance, or (b) based upon a level of performance that is substantially certain to be met at the time the criteria are established. Performance-based compensation generally may include payments based upon subjective performance criteria, if (a) those criteria relate to the performance of the employee, a group of employees that includes the employee, or a business unit for which the employee provides services (which may include the entire organization), and (b) the determination that the subjective performance criteria have been met is not made by the employee or a member of the employee's family, or a person the employee supervises or over whose compensation the employee has any control.

The proposed regulations would permit performance criteria to be established up to 90 days after commencement of the period of service to which the criteria relates, if the outcome is not substantially certain at that time. At the time of an initial deferral election, however, either the amount of the compensation must not be readily ascertainable, or the right to the amount must not be substantially certain.

Performance-based compensation may be based solely upon an increase in the value of the employer or the stock of the employer after the date of grant or award. However, if an amount of compensation is not based solely on an increase in the value of the employer's stock after the grant or award (for example, as with restricted stock units or a stock right grant with an exercise price that is less than the fair market value of the stock as of the date of grant), none of the compensation attributable to the grant or award will be performance-based compensation unless the other amount itself qualifies as performance-based compensation. Nonetheless, such an award of equity-based compensation may constitute performance-based compensation if entitlement to the compensation is itself subject to a performance-based vesting condition.

We discussed earlier the exception from the 409A rules for nondiscounted stock rights. That exception applies only where the stock rights have no feature for the deferral of compensation other than that inherent in the nature of a stock option or SAR. In contrast, a stock right with a deferral feature is subject to Section 409A from the date of grant. The arrangement would, therefore, need to specify a permissible payment time and a form of payment. This requirement will not be met if, at some point during the term of the stock right, the stock right becomes immediately exercisable and the employee may decide whether and when to exercise the right. In addition, where a deferral feature is added to an existing stock right, the stock right generally will violate Section 409A because it will have a deferral feature and will not have specified a permissible payment time or event.

**First Year of Eligibility**. The normal December 31 deadline for initial deferral elections is relaxed for newly eligible participants. In particular, a plan may permit a newly eligible employee to make a deferral election within the first 30 days of his or her participation in the plan. This election may, however, apply only to compensation for services performed after the election. In the case of compensation earned based on a specified performance period (for example, an annual bonus), this first year election is deemed to apply to compensation for services performed after the election (as required) if the election applies only to a portion of the compensation that is no greater than (a) the total amount of the compensation for the performance period, multiplied by (b) the ratio of (i) the number of days remaining in the performance period after the election, over (ii) the total number of days in the performance period.

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**Deferring Short-Term Deferrals**. As noted earlier, amounts paid under the 2-1/2 month rule for short-term deferrals are not subject to Section 409A. An employee may, however, be permitted to defer payment beyond the short-term deferral period, in which case Section 409A would apply. An employee may be permitted to defer payment beyond the time payment originally was scheduled by following the 409A rules for subsequent changes in the time and form of payment. (These rules are described later in this newsletter.) In general, this means the employee must make his or her election at least 12 months before the right to the payment vests, and must defer payment for a period of not less than five years from the date the right to the payment could vest. As a consequence, no payments can be made within five years of the date the right to the payment vests (including upon separation from service), except in the case of a change in control of the corporation, death, disability, or an unforeseeable emergency. This also means if the right to the payment actually vests within 12 months of the election, and the election is given effect so the payment is not made within the short-term deferral period, deferral of the payment would violate Section 409A.

To take an example, assume an employee may be entitled to the immediate payment of a bonus upon the occurrence of an initial public offering ("IPO"). Assume also that this condition qualifies as a substantial risk of forfeiture so the arrangement would constitute a short-term deferral. At some point after obtaining a right to payment, but before the IPO, the employee elects to defer any potential bonus payments to a date five years from the date of the IPO. To comply with the initial deferral election rules, this deferral election must not be given effect for 12 months. Accordingly, if the IPO occurs within 12 months of the deferral election, payment must be made at the time of the IPO in accordance with the short-term deferral rules. If payment is not made at that time, but rather is made, for example, five years from the date of the IPO, that payment would be deemed deferred pursuant to an invalid initial deferral election effective before the required lapse of 12 months. The arrangement would, therefore, violate Section 409A. The proposed regulations get to this result conceptionally by (a) treating the date the substantial risk of forfeiture lapses as the original time of payment established by a fictitious initial deferral election, and (b) treating the form in which the payment would be made absent a deferral election (that is, under the original short-term deferral program) as the original form of payment established under the fictitious initial deferral election.

**Initial Deferral Elections for Certain Forfeitable Rights**. Commentators had asked the IRS how the initial deferral election rules could be satisfied for grants of nonqualified deferred compensation that occur in the middle of a year, especially where the grant was unforeseeable by the employee. The IRS acknowledged that under these circumstances an initial deferral election could not be made by December 31 of the year preceding the grant, unless the employee had the foresight to request an election in that prior year. The proposed regulations would, therefore, offer partial relief by providing that where a grant of nonqualified deferred compensation is subject to a forfeiture condition requiring the continued performance of services for a period of at least 12 months, an initial deferral election may be made no later than 30 days after the date of grant. This relief will apply, however, only where the election is made at least 12 months in advance of the end of the service period. This results in the election being made at least 12 months before the employee has fully earned the compensation. The rule is intended to be of help in the case of grants of certain ad hoc awards, such as restricted stock units, that are subject to a requirement that the employee continue to perform services for at least 12 months.

**Initial Deferral Election for Fiscal Year Compensation**. The legislative history to Section 409A suggests that a special deadline should apply to initial deferral elections for compensation paid by employers (or other service recipients) with fiscal years other than the calendar year. The proposed

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regulations would establish such a rule, generally permitting an initial election to defer fiscal year compensation to be made on or before the end of the fiscal year immediately preceding the first fiscal year in which any services are performed for which the compensation is paid. For this purpose, fiscal year compensation does not, however, include all compensation paid by a fiscal year employer. Where compensation is not specifically based upon an employer's fiscal year as the measurement period, the normal timing requirements applicable to initial deferral elections described above would apply unchanged. As a result, the special rule applies to compensation that is based on service periods that are co-extensive with one or more of the employer's consecutive fiscal years, where no amount of the compensation is payable during that service period. For example, a bonus based upon a service period of two consecutive fiscal years, payable after the completion of the second year, would be fiscal year compensation. In contrast, periodic salary payments or bonuses based on service periods other than the employer's fiscal year would not be fiscal year compensation, and the deferral of those amounts would be subject to the general timing rule for initial deferral elections.

**Commissions**. The proposed regulations would also address the treatment of commissions earned by employees (or other service providers), where a substantial portion of the employees' services consist of the direct sale of a product or service to a customer, each payment consists of a portion of the purchase price or an amount calculated solely by reference to the volume of sales, and each compensation payment is contingent upon the employer receiving payment from an unrelated customer for the product or services. In those circumstances, the employee (or other service provider) will be treated as having performed the relevant services during the year in which the unrelated customer renders payment. This means an employee could make an initial deferral election with respect to commission compensation as late as December 31 of the calendar year preceding the year in which the customer renders the payment from which the commission is derived.

## What Rules Govern the Time and Form of Payment Under Deferred Compensation Programs?

As noted in our February 19, 2005 newsletter, payments may be made under the Section 409A rules at a fixed date or under a fixed schedule, or upon any of five events: a separation from service, death, disability, change in the ownership or effective control of a corporation, or unforeseeable emergency. Where the time of payment is based upon the occurrence of a specified event (such as one of the five events listed above or, as discussed later in the section on "Specified Time or Fixed Schedule of Payments," upon the lapse of a substantial risk of forfeiture), the plan must designate an objectively determinable date or year following the event upon which the payment is to be made. For example, a plan may designate the payment date as 30 days following a separation from service, or the first calendar year following an employee's death.

**Payment by Date Administratively Feasible**. The IRS acknowledged in the proposed regulations that it may not be administratively feasible to make payment upon the exact date or year designated by a plan. The regulations, therefore, would treat a payment as made upon the plan's designated date if the payment is made by the later of (a) the end of the calendar year containing the designated date (or when only a year is designated, the end of that calendar year), or (b) the $15^{th}$ day of the third calendar month following the designated date.

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“[W]here the calculation of an amount of a payment is not administratively practicable, payment may be made during the first calendar year in which the payment is administratively practicable.”

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In addition, where the calculation of an amount of a payment is not administratively practicable, payment may be made during the first calendar year in which the payment is administratively practicable. To avoid abuse, however, any inability to make payment that is caused by action or inaction of the employee or the employee’s estate will not be treated as causing the payment to be administratively infeasible. There is a similar rule in the case of employer insolvency. In particular, where the funds of an employer are not sufficient to make payment on the designated date without jeopardizing the solvency of the employer, payment will be treated as made on the plan’s designated date if payment is made during the first calendar year in which the employer’s funds are sufficient to make payment without jeopardizing the employer’s solvency.

**Changing Time and Form After Payment Event Has Occurred**. An employee may change the time and form of payment after the occurrence of the event upon which the payment is to be made, if the change would otherwise be timely and permissible under the proposed regulations. As an example, consider a plan that provides for a lump sum payment on the third anniversary following separation from service. Consider further an employee who has a separation from service on July 1, 2010. The July 1, 2013 payment date is treated as the fixed date upon which payment is to be made. Accordingly, the employee generally could elect to defer the time and form of payment, provided that the election were made on or before June 30, 2012, and deferred payment to at least July 1, 2018.

**Specified Time or Fixed Schedule of Payments**. Generally, under the proposed regulations, a plan will be deemed to provide for a specified time or fixed schedule of payments where, at the time of deferral, the specific date upon which the payment or payments will be made may be objectively determined. The proposed regulations permit plans to simply specify the calendar year or years in which payments are scheduled to be made, without specifying the particular date within a year on which payment will be made. This raises a question as to how the rules permitting subsequent deferrals operate where a year, rather than a particular date, is specified. The question arises because where an amount is payable at a specified time or per a fixed schedule, and the plan permits a delay in payment under a subsequent election, the plan must require that the subsequent election be made at least 12 months prior to the date of the first scheduled payment. So, where only a year of distribution is specified, when is the first scheduled payment considered to occur? For a plan that designates only the year in which payment is to be made (rather than a specified date), the first scheduled payment is, under the proposed regulations, deemed to be scheduled to be paid as of January 1 of that year.

In addition, the proposed regulations provide a special rule that applies where vesting is based upon the occurrence of an event. A plan will be considered to provide for payment at a specified time or per a fixed schedule if the plan provides, at the time of deferral, that payment will be made at a date or dates that are objectively determinable based upon the date of the lapsing of a substantial risk of forfeiture. In determining when a substantial risk of forfeiture lapses, any acceleration of vesting due to death or disability is ignored. So, for example, a plan that provides that payments will be made in three annual installments each December 31 following an initial public offering (where the condition that an IPO occur constitutes a substantial risk of forfeiture) would satisfy the requirement that the plan provide for payments at a specified time or pursuant to a fixed schedule.

**Separation from Service**. Another permissible payment event is separation from service. An employee will be considered to have experienced a separation from service if he or she dies, retires, or otherwise has a termination of employment with the employer. An employment relationship will, however, be treated as continuing intact while an individual is on military leave, sick leave, or other bona fide leave of absence (such as temporary employment by the government) if the period of that leave does not exceed six months, or if longer, so long as the individual's right to reemployment with the employer is provided either by statute or by contract. If a period of leave exceeds six months and the individual's right to reemployment is not provided for either by statute or by contract, the employee's employment relationship will be deemed to terminate on the first date immediately following expiration of the six month period.

Whether an employee has experienced a termination of employment is to be determined based on the particular facts and circumstances. The IRS does not intend that the standard for separation from service permit the extension of deferrals through the use of consulting agreements or other devices under which an employee technically agrees to perform services as demanded, but for which there is no intent that the employee actually perform any significant services. As a result, the proposed regulations set forth an anti-abuse rule under which an employee will be treated as having terminated employment and had a separation from service where the facts and circumstances indicate that the employer and employee did not intend for the employee to provide more than insignificant services for the employer in the future. The employee will be considered terminated even though the employer may have a contractual right to require the employee to be available to perform services if requested. For this purpose, an employer and employee will be deemed to have intended for the employee to provide more than insignificant services, and therefore not to have suffered a separation from service triggering a distribution, if the employee provides services at an annual rate equal to at least 20 percent of the services rendered during the immediately preceding three full calendar years of employment (or, if the employee was employed for less than three years, that lesser period), and the annual remuneration for those services is equal to at least 20 percent of the average remuneration earned during that same period.

*"[A]n employee will be treated as having terminated employment . . . where the facts and circumstances indicate that the employer and employee did not intend for the employee to provide more than insignificant services . . . in the future."*

Just as the standard for separation from service is not intended to permit the *extension* of deferrals, it is not intended to permit the *acceleration* of deferrals. In particular, a formal termination of employment may be disregarded. For example, where an employee continues to provide services to a prior employer in a capacity other than as an employee, such as continuing on as an independent contractor, a separation from service will be treated as not having occurred if the former employee provides services at an annual rate that is 50 percent or more of the services rendered, on average, during the final three calendar years of employment (or, if the employee was employed for less than three years, that lesser period) and the annual remuneration for those services is 50 percent or more of the average annual remuneration earned during that same period.

The IRS has made clear that although Section 409A uses the phrase "separation from service," which is the same phrase used under the old "same desk rule" applicable to Section 401(k) plans, the same desk rule does not apply in determining what constitutes a separation from service for purposes of the 409A rules.

**Delay for Key Employees**. Payments upon a separation from service of a key employee of a corporation the stock of which is publicly traded on an established securities market must be delayed at least six months following separation. In general, a key employee for this purpose is a key employee under the top-heavy rules applicable to qualified retirement plans.

The proposed regulations set forth rules governing when the determination of whether an individual is a key employee must be made. In particular, the identification of key employees will be based on the 12 month period ending on an identification date chosen by the employer. Persons who meet the requirements for being key employees during that 12 month period are considered key employees for the 12 month period commencing on the first day

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of the fourth month following the end of the 12 month period. For example, if an employer chooses December 31 as an identification date, any key employees identified during the calendar year ending December 31 would be treated as key employees for the 12 month period commencing the following April 1. Employers may choose an identification date other than December 31, so long as the date chosen is used consistently, and provided that any change in the identification date is not effective for a period of at least 12 months.

To meet the six month delay requirement, a plan may provide that any payment pursuant to a separation from service due within the six month period will be delayed until the end of the six month period, or, alternatively, that each scheduled payment payable pursuant to a separation from service will be delayed six months, or a combination of the two. A plan may be amended to specify or change the manner in which the six month delay will be implemented, but only if the amendment is not effective for at least 12 months. A plan may even provide employees with an election as to the manner in which the six month delay will be implemented, if that election is subject to the otherwise applicable deferral election rules.

**Disability**. An employee will be disabled for purposes of the distribution rules if the employee (a) is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, or (b) is, by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident or health plan covering employees of the employer. Under the proposed regulations, a plan may provide that an employee will be deemed disabled if he or she is determined to be totally disabled by the Social Security Administration.

**Multiple Payment Events**. In welcome relief, the proposed regulations permit a plan to provide that payments may be made upon the earlier of, or the later, of two or more specified permissible payment events or times. A different form of payment may be elected for each potential payment event. For example, a plan can provide that an employee will receive an installment payment upon separation from service or, if earlier, a lump sum payment upon death.

**Delay in Payment by Employer**. The proposed regulations offer employers a limited ability to delay payments due under a nonqualified deferred compensation plan without violating the requirements of Section 409A. In particular, the proposed regulations provide generally that in the case of (a) payments the deduction for which would be limited or eliminated by the $1 million limitation of Tax Code § 162(m), (b) payments that would violate securities or other laws, or (c) payments that would violate loan covenants or other contractual terms to which the employer is a party, where violation of the loan covenant or contractual term would result in material harm to the employer, the plan may provide that the payment will be delayed. A plan may be amended to add a provision providing for such a delay, but the amendment could not be effective for a period of at least 12 months. If a plan were amended to remove such a provision with respect to amounts previously deferred, the amendment would constitute a prohibited acceleration of payment.

In the case of amounts for which a deduction would be limited or reduced by application of the $1 million limitation of Section 162(m), payment can be deferred either to a date in the first year in which the employer reasonably anticipates that the payment will not result in a limitation of a deduction, or the year in the which the employee separates from service. With respect to amounts that would violate loan covenants or similar contracts, or would result in a violation of federal securities laws or other applicable laws, the arrangement must provide that the payment will be made in the first calendar year in which the employer reasonably anticipates the payment would not violate the loan or contractual terms, the violation of the loan or other contractual terms would not result in material harm to the employer, or the payment would not result in a violation of federal securities laws or other applicable laws.

**Disputed Payments and Refusals to Pay**. The proposed regulations address possible violations of Section 409A due to an employer's refusal to pay deferred compensation when due. This could occur either where the employer disputes the amount of the payment or simply refuses to pay. In either situation, the proposed regulations generally provide that the payment will be deemed to be made upon the date scheduled, if the employee is acting in good faith and makes reasonable, good faith efforts to collect the amount. Factors used in determining whether an employee is acting in good faith and making reasonable, good faith efforts to collect include the amount of the payment or the portion of the payment in dispute, as well as the size of the disputed portion in relation to the entire payment. Although payment may be delayed, payment may not be made subject to a subsequent deferral election, but must instead be made by the later of the end of the calendar year in which, or the 15th day of the third month following the date that, the employer and the employee enter into a legally binding settlement of the dispute, the employer concedes that the full amount is payable, or the employer is required to make the payment pursuant to a final and nonappealable judgment or other binding decision. An employee will be treated as having requested that a payment not be made, rather than the employer having refused to make payment, where the decision that the employer will not make payment is made by the employee, or by any person or group of persons under the supervision of the employee at the time the decision is made.

**Acceleration**. In general, payments of deferred compensation may not be accelerated, except as provided in IRS regulations. Notice 2005-1 did, however, list certain permissible payment accelerations, including payments necessary to comply with a domestic relations order, payments necessary to comply with certain conflict of interest rules, payments intended to pay employment taxes, and certain de minimis payments related to a participant's termination of his or her interest in the plan. The proposed regulations would also permit a plan to accelerate distribution to pay amounts includible in income as a result of failing to meet the requirements of Section 409A. An amount will have been deemed to be included in income for this purpose if it was timely reported on Form W-2 or Form 1099-MISC.

**Plan Termination**. The proposed regulations provide limited, though welcome, relief from the rules governing the time and form of payments where a nonqualified deferred compensation arrangement is terminated. A number of commentators had asked that employers be allowed to retain the right to accelerate payment upon termination of an arrangement, where that termination is at the discretion of the employer. The IRS declined to grant a blanket exemption permitting such acceleration, but did describe three circumstances in which a plan can be terminated, with distribution accelerated. The first concerns an employer that wants to cease providing a certain category of nonqualified deferred compensation entirely. A plan can be terminated, with distribution accelerated, if (a) all arrangements of the same type (account balance plans, nonaccount balance plans, separation pay plans, or equity-based arrangements) are terminated with respect to all participants, (b) no payments other than those otherwise payable under the terms of the plan absent a termination of the plan are made within 12 months of the termination, (c) all payments are made within 24 months of termination of the arrangement, and (d) the employer does not adopt a new arrangement that would be aggregated with any terminated arrangement for a period of five years following termination.

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"[A] plan may permit an employee to make a subsequent election to further delay a payment, or to change the form of a payment [if certain conditions are met]."

Under a second exception, a corporate employer may, during the 12 months following a change in control of the corporation, elect to terminate a plan and make payments to participants. Under a third exception, a plan may provide that the plan terminates upon certain corporate dissolutions, or with the approval of a bankruptcy court, provided that the amounts deferred are included in participant's gross income by the latest of (1) the calendar year in which the plan termination occurs, (2) the calendar year in which the amounts are no longer subject to a substantial risk of forfeiture, or (3) the first calendar year in which the payments are administratively practicable.

**Unforeseeable Emergency or Hardship Distribution: Termination of Deferral Election**. The IRS noted that under the Section 401(k) plan rules, a participant normally must halt elective deferrals of compensation to nonqualified plans after receiving a hardship distribution from the 401(k) plan. The proposed regulations, in recognition of this requirement, permit a nonqualified deferred compensation plan to provide that a deferral election will terminate if required for an employee to obtain a hardship distribution under a 401(k) plan. In addition, a plan may provide that a deferral election will terminate if the employee obtains a payment under the nonqualified plan due to an unforeseeable emergency. In each case, the deferral election must be terminated, not merely suspended. A deferral election made after termination of a prior election due to an unforeseeable emergency or a Section 401(k) hardship distribution will be treated as an initial deferral election, subject to the normal timing rules for those elections. The proposed regulations would also permit distributions to be made from a nonqualified plan as necessary to avoid a nonallocation year under an S corporation ESOP.

**Subsequent Changes in the Time and Form of Payment**. Although distributions may not be accelerated under Section 409A, a plan may permit an employee to make a subsequent election to further delay a payment, or to change the form of a payment. A subsequent election to do so will be permissible only if:

- The plan requires that the election not take effect until at least 12 months after the date on which the election is made

- In the case of an election related to a payment other than a payment on account of death, disability, or the occurrence of an unforeseeable emergency, the plan must require that the first payment with respect to which the election is made be deferred for a period of at least five years from the date the payment would otherwise have been made (the "five-year rule"), and

- The plan requires that any election related to a payment at a specified time or pursuant to a fixed schedule be made at least 12 months prior to the date of the first scheduled payment.

The proposed regulations clarify the application of the five-year rule to distributions made in the form of a stream of payments, such as installment payments. The question is whether individual installments are treated as separate payments or as one payment. Under the proposed regulations, each separately identified amount to which an employee is entitled on a determinable date is a separate payment. Therefore, if an amount is separately identified as a payment, either because the right arises under a separate arrangement or because the arrangement simply identifies the amount as a separate payment, the amount will not be aggregated with other amounts for purposes of the rules relating to subsequent changes in the time and form of payment and the prohibition on acceleration. For example, an arrangement may provide that 50 percent of a benefit is paid as a lump sum at separation from service, and the remainder is paid as a lump sum at age 60, which would identify each amount as a separate payment. Once a payment has been separately identified, the

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payment may only be aggregated with another payment if that aggregation would otherwise comply with rules relating to subsequent changes in the time and form of payment.

With respect to installment payments, an entitlement to a series of installment payments is generally to be treated as a single payment for purposes of the subsequent deferral rules. The proposed regulations do, however, allow an arrangement to instead specify that a series of installment payments will be treated as a series of separate payments. So, the plan terms will determine the treatment of installment payments. Generally, it would seem better to treat a series of installments as a single payment, as the following example illustrates. If a five-year installment payment is treated as a single payment and is scheduled to commence on July 1, 2010, the employee could, consistent with the five-year rule, change the time and form of the payment to a lump sum payment on July 1, 2015, provided the other conditions related to a change in the time and form of payment are met. In contrast, if a five-year installment payment is designated as five separate payments scheduled for the years 2010 through 2014, the employee could not change the time and form of the payment to a lump sum payable on July 1, 2015, because the separate payments scheduled for the years 2011 through 2014 would not have been deferred at least five years. Instead, the employee could change the time and form of payment to a lump sum only if the payment were scheduled to occur no earlier than 2019 (five years after the last of the originally scheduled payments).

The proposed regulations also create a special rule for life annuities. Entitlement to a life annuity is treated as a single payment. Plans may not choose to treat a life annuity as a series of separate payments.

**Multiple Payment Events**. As noted earlier, a plan may provide that a payment will be made upon the earlier of, or the later of, multiple specified permissible payment events. In addition, a plan may provide for a different form of payment depending upon the payment event. For example, a plan may provide that an employee is entitled to an annuity at age 65 or, if earlier, a lump sum payment upon separation from service.

*"[A] plan may provide for a different form of payment depending upon the payment event."*

Where there are multiple potential payment events, and possibly multiple forms of payment, the proposed regulations apply the subsequent deferral rules for changing the time and form of payment (and the anti-acceleration rules) to each payment event separately. So, in the example above, the rules would apply separately to the employee's entitlement to the installment payment at age 65 and his or her entitlement to a lump sum payment at separation from service. As a result, the employee could delay the annuity payment date (under the rules governing changes in the time and form of payment), while retaining a separate right to receive a lump sum payment at separation from service if that were to occur at an earlier date. In that case, the five-year rule would apply to the annuity payment date (delaying payment from age 65 to at least age 70), but not to the unchanged lump sum payment available upon separation from service before age 70.

In similar fashion, a plan may provide that an intervening event (that is a permissible payment event) may override an existing payment schedule already in pay status. For example, a plan could provide that a participant will receive six installment payments commencing at separation from service, but if the participant dies after payment commences, all remaining benefits will be paid in a lump sum.

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*"[A] change in an employee's 401(k) deferral election will not result in violation of the Section 409A rules with respect to the wrap plan."*

Generally, the addition to a plan of a new payment event, or a fixed time or fixed schedule of payments, will be subject to the rule governing changes in the time and form of payment and the anti-acceleration rules. As a result, no fixed time of payment could be added that did not defer payment for at least five years from the date the fixed time is added. In addition, no payment due to any other added permissible event could be made within five years of the addition of the event. For example, an employee entitled to a payment only on January 1, 2050, could not make a subsequent deferral election to be paid on the later of January 1, 2050, or separation from service, but could make a subsequent deferral election to be paid on the later of separation from service or January 1, 2055.

## What Rules Apply to Wrap 401(k) Plans and Other Plans Linked to Qualified Plans?

Early comments from IRS and Treasury officials caused many to worry that 401(k) wrap plans could not operate consistent with the Section 409A rules. Fortunately, the proposed regulations make some accommodation for these programs. Specifically, the proposed regulations provide that a change in an employee's 401(k) deferral election which would affect the amount deferred under a wrap program will not be treated as either a deferral election or an acceleration of payment under the wrap plan. This means a change in an employee's 401(k) deferral election will not result in violation of the Section 409A rules with respect to the wrap plan. This relief applies only if, for any given calendar year, the employee's action or inaction in making 401(k) elections does not cause the total amounts deferred under all nonqualified deferred compensation plans in which the employee participates to increase or decrease by an amount exceeding the Tax Code Section 402(g) limit ($14,000 in 2005; $15,000 in 2006, not counting catch-up contributions).

Similar relief is provided with respect to matching contributions. In particular, an employee's election as to the amount he or she chooses to contribute as an elective deferral or after-tax contribution to a qualified plan that affects the matching or other contingent contributions to be made under the nonqualified plan will not be treated as a deferral election or an acceleration. This relief applies only if (a) the matching or contingent amounts are either forfeited or never credited under the nonqualified plan if the employee makes no elective deferral or after-tax contribution under the qualified plan, and (b) the employee's action or inaction under the qualified plan does not result in an increase or decrease in the amount deferred under all nonqualified plans in which the employee participates in an amount exceeding the Section 402(g) limit (again, $14,000 in 2005; $15,000 in 2006, not counting catch-up contributions).

The proposed regulations also provide limited relief with respect to nonqualified plans linked to qualified retirement plans other than in a wrap 401(k) arrangement. In particular, the proposed regulations provide that where the amount deferred under a nonqualified plan is an amount determined under the formula for determining benefits under a qualified retirement plan, but disregarding one or more Tax Code limitations applicable to qualified plans (such as the Section 415 benefit limitations, the Section 401(a)(17) compensation limitation, or the Section 402(g) elective deferral dollar limitations), or is determined as an amount offset by some or all of the benefits provided under a qualified retirement plan, the operation of the qualified plan with respect to changes in the Tax Code benefit limitations will not constitute a prohibited acceleration of payment under the nonqualified arrangement. This will be the case even though an increase in those Tax Code limitations may effectively result in a decrease in amounts deferred under the nonqualified plan.

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"The new 409A rules generally apply to amounts deferred on or after January 1, 2005."

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In addition, with respect to these same nonqualified plans, there will be no prohibited acceleration of payment on account of the following actions or failures, even if the result is to decrease amounts deferred under the nonqualified arrangement:

- The amendment of the qualified plan to increase or decrease benefits
- The cessation of future accruals under the qualified plan
- The addition, removal, increase, or reduction of a subsidized benefit or ancillary benefit under the qualified plan, or a participant's election whether to receive a subsidized benefit or ancillary benefit under the qualified plan.

Although the proposed regulations provide some accommodation for nonqualified plans linked with qualified plans, they retain the prohibition on tying the time and form of distribution under a nonqualified plan to the time and form of benefit payment elected under a qualified retirement plan. As a result, it remains impermissible for distributions under nonqualified plans to be paid at the time and in the form an employee later chooses for receiving his or her qualified retirement plan benefits.

## What Effective Date and Transition Rules Apply?

The new 409A rules generally apply to amounts deferred on or after January 1, 2005. An amount is considered deferred before January 1, 2005, and therefore not subject to Section 409A, if the employee (a) had a legally binding right to be paid the amount, and (b) the right to the amount was earned and vested as of December 31, 2004. A right to an amount will be considered earned and vested only if the amount is not subject to either a substantial risk of forfeiture or a requirement to perform further services.

The proposed regulations clarify when a stock right or similar right to compensation will be treated as earned and vested. Stock rights often terminate upon separation from service. Commentators had asked whether this meant such a right will not have been earned and vested, since future services would be required to *retain* the right. The proposed regulations clarify that a stock right (or similar right) will be treated as earned and vested by December 31, 2004, if on or before that date the right was either immediately exercisable for a payment of cash or substantially vested property, or was not forfeitable. As a result, stock options that on or before December 31, 2004, were immediately exercisable for substantially vested stock generally would not be subject to Section 409A. In contrast, a nonstatutory stock option that was immediately exercisable on or before December 31, 2004, but only for substantially nonvested stock, generally would be subject to Section 409A.

**Calculation of Grandfathered Amounts**. For account balance plans, the grandfathered amount not subject to Section 409A generally will be an employee's vested account balance as of December 31, 2004, plus any earnings with respect to those amounts. For plans that are neither account balance plans nor nonaccount balance plans (generally equity-based compensation), the grandfathered amount generally will be the payment that would be available if the right were exercised on December 31, 2004, and any earnings with respect to that amount. Earnings generally would include, for this purpose, any increase in the payment available due to appreciation in the underlying stock.

"Grandfathered plans will become subject to Section 409A upon any material modification, even if that modification occurs many years in the future."

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As to nonaccount balance plans, the grandfathered amount is the present value as of December 31, 2004, of the amount to which the employee would be entitled if he or she voluntarily terminated services without cause on December 31, 2004, and received a payment of benefits with the maximum value available from the plan, on the earliest possible date allowed under the plan for receiving benefit payments following termination of services. This rule will effectively take into account the value of any subsidized benefit to which the employee was eligible on December 31, 2004. For any subsequent calendar year, the grandfathered amount may, however, increase to equal the present value of the benefit the employee actually becomes entitled to, determined under the terms of the plan (including any applicable limits under the Tax Code) as in effect on October 3, 2004, without regard to any further services rendered by the employee after December 31, 2004, or any other events affecting the amount of or the entitlement to benefits (other than the participant's survival or election with respect to the time or form of benefit).

As noted earlier, there is a fourth category of plans comprising separation pay plans with respect to involuntary terminations and early retirement window programs. For this category of plans, the proposed regulations would, by analogy, apply the principles described above for calculating grandfathered amounts under nonaccount balance plans and account balance plans, depending on the structure of the separation pay plan.

**Material Modifications to Grandfathered Plan**. Grandfathered plans will become subject to Section 409A upon any material modification, even if that modification occurs many years in the future. The proposed regulations provide some very limited relief to avoid an inadvertent loss of grandfathered status in this way. In particular, to the extent a modification is rescinded before the earlier of (a) the date any additional right granted under the modification is exercised, or (b) the end of the calendar year in which the modification was made, the modification will not be treated as material. For example, if a subsequent deferral feature is added to a nonqualified plan that allows a participant to extend the time and form of payment of a grandfathered deferred amount, and if that right is removed before the earlier of the time the participant exercises the right or the end of the calendar year, the modification will not be treated as a material modification of the plan. This exception is not, however, intended to cover a material modification that is made with the knowledge that the modification will cause the plan to lose its grandfathered status, but is then rescinded.

**Transition Relief**. Notice 2005-1 offered various forms of transition relief for the 2005 calendar year. Much, but not all, of this relief has been extended by a year through 2006. Importantly, this extension includes the deadline for amending plan documents to conform with the requirements of Section 409A and the regulations thereunder. As a result, the deadline by which plans must be amended has been extended to December 31, 2006. Although amendments are not required until the end of 2006, a plan must, in the interim, be operated in good faith compliance with the provisions of Section 409A and Notice 2005-1. To the extent an issue is not addressed in Notice 2005-1 or other published guidance, a plan must follow a good faith, reasonable interpretation of the statute, and, to the extent not inconsistent therewith, the plan's terms. Although the proposed regulations will not become effective before January 1, 2007, compliance with the proposed regulations will be considered good faith compliance with the statute.

A plan will not be considered to operate in good faith compliance if the employer exercises its discretion under the terms of the plan, or an employee exercises discretion with respect to the employee's benefits, in a manner that causes the plan to fail to meet the requirements of Section 409A. For example, if an employer retains discretion under the terms of the plan to delay or extend payments and exercises that discretion, the plan will not be in good faith

"[A] plan may be amended to permit a participant to make a new payment election . . . if the plan is amended to so provide and the participant makes his or her election on or before December 31, 2006."

compliance with respect to any plan participant. An exercise of a right under the terms of the plan by an employee solely with respect to that employee's benefits in a manner that causes the plan to fail Section 409A will not, however, be considered to result in the plan failing to be operated in good faith compliance with respect to other participants. So, for example, if an employee were to request and receive a distribution under the terms of the plan's haircut provision, under which the employee can receive an immediate payment if he or she forfeits 20 percent of his or her benefits, this acceleration would be considered a failure of the plan to meet the requirements of Section 409A with respect to that employee, but not with respect to other employees.

**Changes in Payment Elections.** With respect to amounts subject to Section 409A and amounts that would be treated as short-term deferrals (under the rules described earlier), a plan may be amended to permit a participant to make a new payment election, without violating the subsequent deferral and anti-acceleration rules, if the plan is amended to so provide and the participant makes his or her election on or before December 31, 2006. A participant may not, however, in 2006 change a payment election with respect to payments the participant would otherwise receive in 2006, or cause payments to be made in 2006 that would not otherwise be payable in 2006. Consistent with this rule, an outstanding stock right that provides for a deferral of compensation subject to Section 409A may be amended to provide for fixed payment terms consistent with Section 409A, or to permit holders of those rights to elect fixed payment terms consist with Section 409A, provided that the option or other right is so amended and any elections are made on or before December 31, 2006.

**Payments Tied to Qualified Plan Distributions**. As noted earlier, Section 409A does not permit the time and form of payment under a nonqualified deferred compensation plan to be controlled by the time and form of payment elected by an employee under a qualified retirement plan. Nevertheless, for periods ending on or before December 31, 2006, an election as to the timing and form of payment under a nonqualified plan that is controlled by a payment election made by an employee or beneficiary of the employee under a qualified plan will not be considered to violate Section 409A. This relief applies only if the determination of the timing and form of the payment is made in accordance with the terms of the nonqualified plan governing payment, as those terms were in effect as of October 3, 2004. So, if a nonqualified plan provides as of October 3, 2004, that the time and form of payment to an employee or beneficiary will be the same as the time and form of payment elected by the employee or beneficiary under a related qualified plan, it will not be a violation of Section 409A for the plan administrator to make or commence payments under the nonqualified plan on or after January 1, 2005, and on or before December 31, 2006, pursuant to the payment election made under the related qualified plan.

**Initial Deferral Elections**. Notice 2005-1 had provided temporary relief from the initial deferral election requirements. In general, that relief had permitted initial deferral elections with respect to compensation for services performed on or before December 31, 2005, to be made on or before March 15, 2005. This March 15, 2005 deadline has *not* been extended. As a result, plans must observe the strict deadlines under Section 409A for making initial deferral elections.

**Cancellation of Deferrals and Termination of Plan Participation**. The proposed regulations do not extend the December 31, 2005 deadline for permitting participants to terminate participation in a plan, or cancel an outstanding deferral election with regard to amounts subject to Section 409A. If an employer wishes to offer participants this opportunity, it will need to amend its plan by December 31, 2005, to so provide, and participants will need to make

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their elections by that date. The amount subject to termination or cancellation must be includible in the participant's income in calendar year 2005 or, if later, in the year in which the amounts are earned and vested. A termination or cancellation permitted under these rules is treated as effective as of January 1, 2005, and may apply in whole or in part to one or more plans in which the employee participates and to one or more outstanding deferral elections the employee has made with regard to amounts subject to Section 409A. The exercise of a stock option, stock appreciation right or similar equity appreciation right that provides for a deferral of compensation on or before December 31, 2005, will be treated as a cancellation of a deferral.

**Termination of Grandfathered Plans**. Notice 2005-1 provides that amending an arrangement on or before December 31, 2005, to terminate the arrangement and distribute amounts of deferred compensation thereunder will not be treated as a material modification (so as to subject grandfathered amounts to the Section 409A rules), so long as all amounts deferred under the plan are included in income in 2005. This December 31, 2005 deadline for plan terminations has not been extended. A plan amendment to provide participants with a right to *choose* whether to terminate participation or to continue to defer amounts is not covered by this relief, and therefore would constitute a material modification. Accordingly, amounts that were not distributed pursuant to such an election, and continued to be deferred under the plan, would be subject to Section 409A.

**Substitution of Nondiscounted Stock Rights for Discounted Rights**. Notice 2005-1 provides that it will not be a material modification to replace a stock option or stock appreciation right otherwise subject to Section 409A (generally, a discounted stock option or SAR) with a stock option or stock appreciation right that would not have constituted a deferral under Section 409A had it been granted on the original date of grant of the replaced stock option or stock appreciation right. Notice 2005-1 required that this cancellation and reissuance occur on or before December 31, 2005. This deadline has been extended to December 31, 2006, but only to the extent the cancellation and reissuance does not result in cancellation of a deferral in exchange for cash or vested property in 2006. For example, a discounted option generally may be replaced through December 31, 2006, with an option that would not have provided for a deferral of compensation, but the exercise of such a discounted option in 2006 before the cancellation and replacement generally would result in a violation of Section 409A.

Commentators had asked the IRS whether the relief for substituting options covered discounted stock options or SARs that were not earned and vested before January 1, 2005. The proposed regulations provide that where replacement stock options or SARs that would not constitute deferred compensation under Section 409A are issued in accordance with the rules just described, those replacement options or SARs will be treated as if granted on the grant date of the original stock option or SAR. As a result, if the replacement requirements just described are satisfied, a discounted stock option granted in 2003 that was not earned and vested before January 1, 2005, may be replaced with a stock option with an exercise price that would not have been discounted as of the original 2003 grant date, and the substituted stock option will be treated for purposes of Section 409A as granted on the original 2003 grant date. Accordingly, if the substituted stock option would not have been subject to Section 409A had it been granted on the original 2003 grant date, the substituted stock option will not be subject to Section 409A.

*"The proposed regulations do not extend the December 31, 2005 deadline for permitting participants to terminate participation in a plan, or cancel an outstanding deferral election. . .."*

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"[An] issue requiring immediate attention is whether to offer employees the opportunity to cancel deferral elections or terminate their participation in a plan."

The IRS commented on various approaches that employers wanting to compensate employees for a lost stock right discount may choose to take. Under one approach, an employer would pay the amount of the discount in 2005 in cash. The IRS said as a cancellation of a deferral of compensation on or before December 31, 2005, this payment would not be subject to Section 409A. The Service noted, however, that as a payment due to the cancellation of a deferral, the payment could not be made in 2006, since the relief permitting cancellation of deferrals has not been extended beyond December 31, 2005.

Where a stock option remains nonvested during the year of the option substitution, an employer could make the compensation for the lost discount also subject to a vesting requirement. In that case, the employer could grant restricted stock with a fair market value equal to the lost discount, subject to a vesting schedule parallel to the vesting schedule of the substituted option. The IRS concluded that as a transfer of property subject to Section 83 that becomes substantially vested after the year of substitution, this grant would not be subject to Section 409A.

As a third possibility for compensating employees for their lost discount, employers might establish a separate plan, promising a payment for the lost discount (plus earnings) subject to a vesting schedule parallel to the vesting schedule of the substituted option. Provided that the right to the payment becomes substantially vested in a future year and otherwise meets the requirement of the short-term deferral exception to Section 409A, the right to this payment would not constitute deferred compensation subject to Section 409A. Alternatively, such an arrangement could itself provide for the deferral of compensation beyond the year of substantial vesting and be subject to the requirements of Section 409A, but if those requirements are met, would not affect the exclusion of the amended stock option or SAR from treatment as a deferral of compensation subject to Section 409A.

## What to do?

Employers have many decisions to make in determining how best to comply with the 409A requirements. Although employers' nonqualified plans need not be amended until December 31, 2006, those plans must currently be operated in good faith compliance with the requirements of Section 409A, absent any applicable transition relief. Importantly, this means the 409A initial deferral election requirements must be observed. Generally, this will require that voluntary elections to defer be made by December 31 of the year preceding the year in which the services are provided to which the compensation relates. It also means that in the case of nonelective plans (where an employee makes no voluntary deferral), any choice given to an employee as to the time and form of distribution must be made by December 31 of the year preceding the year in which the services are provided to which the compensation relates. It is a bit unclear whether these distribution elections for nonelective deferrals must be made before December 31, 2006, since participants are allowed to change their election as to the timing and form of distribution as late as December 31, 2006, under the 409A transition relief. Nevertheless, the safer approach would be to require that elections as to the time and form of payment be made in a timely fashion, with the plan being amended to afford employees a later opportunity to modify their elections by December 31, 2006.

**Cancellation of Deferrals**. Another issue requiring immediate attention is the decision whether to offer employees the opportunity to cancel deferral elections or terminate their participation in a plan. If employees are to be offered

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*"Employers should give careful consideration to the grandfathered benefit rules."*

such an opportunity, employees' elections must be made by December 31, 2005, and the employer's plan must be amended by that same date to permit those elections. If an employer's original rationale for wanting to provide deferred compensation remains, the employer may, though, have little interest in offering employees this option.

**Wrap 401(k) Plans**. Employers should continue the process of identifying their deferred compensation arrangements, including deferred compensation hidden in employment and severance arrangements. Employers with wrap or tandem 401(k) plans will need to carefully consider whether those programs satisfy the proposed regulations' requirements for such arrangements. Other nonqualified plans linked with qualified retirement plans, such as excess plans and supplemental executive retirement plans (SERPs), which provide for making distribution at the time and form in which benefits are distributed under the linked qualified plan, will need to be modified by December 31, 2006, to provide for freestanding distribution elections. As with all nonqualified plans, an employer must carefully weigh the administrative burden associated with offering many distribution options (and, perhaps, different options with respect to different years' deferrals) with employees' needs for flexibility in planning for distributions which may not occur until many years in the future.

**Grandfathered Benefits**. Employers should give careful consideration to the grandfathered benefit rules. The consequences of inadvertently losing grandfathered status many years in the future, by making a modification that is material, should cause employers to give serious consideration to rejecting the protection of the grandfather rules. Note in this regard that if a plan later loses grandfathered status, it is likely this will result not only in application of an additional 20 percent tax, but also in application of an interest penalty for many prior years. When coupled with the complication of applying separate rules to grandfathered amounts and non-grandfathered amounts, and the availability of substantial transition relief for non-grandfathered amounts subject to Section 409A (such as the ability to change the time and form of payment), there is a powerful argument for avoiding grandfathered status. To do so, however, an employer would need to purposefully make a material modification to its plan. It appears an employer cannot, without making such a material modification, simply elect not to avail itself of the grandfather rules.

There will be much to do in coming months to bring nonqualified deferred compensation plans into compliance with Section 409A. The IRS, in Notice 2005-1 and the proposed regulations, has provided a good foundation for understanding the new and complex rules. Even though the plan amendment deadline has been extended to December 31, 2006, employers should be working now toward compliance with the new requirements.

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