

The Wait Is Over: Proposed Regulations Under Section 409A

The much anticipated second round of guidance under Code section 409A (“409A”) was released through a flurry of downloads and e-mails at the end of last week and officially published yesterday. Issued in the form of proposed regulations, the new guidance builds on that issued last December as Notice 2005-1 and goes well beyond it. In particular, the new 409A proposed regulations (the “Proposed Regulations”) provide detailed operational rules relating to elections and distributions, and they address a range of important issues like when a plan may be terminated (and not just frozen) and how to value private and public company stock. While the Proposed Regulations are – as expected – lengthy, the preamble to the regulations (the “Preamble”) may set something of a record for length. More importantly, however, the Preamble provides additional clarifications, as well as insights into the policy justification for a number of decisions.

Although long, ultimately the regulations are distinguished less by their length than by the tremendous progress they reflect toward workable rules for 409A. *Even with great progress, however, pitfalls remain.* For example, see the exceptions to the extension of the documentary compliance deadline, the rules for benefits and expense reimbursements in severance situations, and the ineligibility of some employees who are hired during a year to use the later deferral deadline for performance-based compensation.

Transition Relief

- **Extension of Certain Transition Rules:** Because final regulations are not yet in place, Treasury and IRS have extended much *but not all* of the transition relief found in Notice 2005-1:
 - **Reliance and Good Faith Compliance:** Treasury and the IRS intend for final regulations to become effective on January 1, 2007. Until then, plans must operate pursuant to a good faith interpretation of 409A. Notice 2005-1 generally continues to apply until final regulations become effective. However, to the extent any provision in the Proposed Regulations or final regulations is inconsistent with a provision of Notice 2005-1, plans may comply with the Proposed Regulations or final regulations provision in lieu of the Notice 2005-1 provision (and compliance with the Proposed Regulations or the resulting final regulations will constitute a good faith interpretation).
 - **Plan Amendments May Be Delayed:** In general, plan amendments may be made as late as December 31, 2006. As under Notice 2005-1, these amendments may bring the plan into compliance with 409A. However, in an important liberalization, they may also be used to convert the plan into an arrangement that is not subject to 409A. *But see below under “Certain Transition Rules Not Extended” for important exceptions to general extension of the documentary compliance deadline.*
 - **Change in Payment Elections:** The period during which a service provider may change payment elections (both as to time and form) without resulting in an impermissible subsequent deferral or acceleration is extended through December 31, 2006. However, there is still no relief from constructive receipt, and 2006 elections may not apply to payments that would otherwise have been received in 2006 or to cause payments to be made in 2006.
 - **Time and Form of Payment Linked to Qualified Plan:** Treasury and the IRS declined to make permanent the 2005 relief provided for nonqualified plan payments that are linked to payments from qualified plans. However, this relief has been extended through December 31, 2006.

INNOVATION IN ACTION: PROACTIVE UPDATES ON CRITICAL ISSUES AND CHANGES IN THE LAWS AFFECTING YOUR BUSINESS

- **Substitution of Non-Discounted Stock Options and SARs for Discounted Stock Options and SARs:** The period during which a discounted option or SAR may be replaced with a non-discounted (based on the original grant date) option or SAR has been extended to December 31, 2006, so long as the option or SAR is not exercised prior to the replacement.
- **Certain Transition Rules Not Extended:** Other transition rules found in Notice 2005-1 have not been extended. Notably:
 - **Right to Cancel Deferrals:** The December 31, 2005, deadline continues to apply for purposes of participant elections to terminate plan participation or cancel deferral elections (in whole or in part) with respect to amounts subject to 409A, and related amounts must still be included in income by December 31, 2005. Any necessary plan amendments to provide for these elections and distributions must be in place by December 31, 2005; *the general extension of the deadline for documentary compliance does not apply for this purpose.*
 - **Plan Termination:** The December 31, 2005, deadline for terminating and making distributions from a pre-October 4, 2004 arrangement without causing a material modification (and related penalties under 409A) has not been extended. *Here again, it appears the termination amendment is due by December 31, 2005.*
 - **Initial Elections by March 15, 2005:** There is no extension or renewal of the opportunity that Notice 2005-1 gave to make initial elections late. *Here again, amendments authorizing use of this transition rule during 2005 are due by December 31, 2005.*

Definition of Nonqualified Deferred Compensation Plan

- **In General:** 409A applies to amounts deferred under a nonqualified deferred compensation plan, which is defined to mean any plan that provides for a deferral of compensation.
- **Exceptions:** The Proposed Regulations set forth a number of exceptions for types of plans that will not be considered nonqualified deferred compensation plans including:
 - **“Qualified” Plans:** Qualified employer plans including any plan, contract or arrangement described in sections 401(a), 403(a), 403(b), 408(k), 408(p), 501(c)(18), 457(b), and 415(m).
 - **Foreign Plans:** Certain foreign plans including mandated social security systems, tax equalization plans under which payments are made within a required time period, plans exempt pursuant to a treaty, broad-based foreign plans covering non-U.S. persons (and covering U.S. persons, who are not in a U.S. plan described above, to the extent of deferrals up to the section 415 limits). Non-U.S. plans that are funded through a traditional trust, and therefore taxable under pre-409A principles, are not covered by 409A.
 - **Certain Welfare Plans:** Certain welfare plans, including any bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan.
 - **Certain Contractor Arrangements:** Arrangements with unrelated independent contractors are generally exempt from 409A if the independent contractor is providing significant services to each of two or more service recipients that are unrelated to each other and to the independent contractor. The Proposed Regulations clarify when services will be considered significant, provide that directors do not fit within this exemption simply because the director serves as a non-employee director to two or more unrelated companies, and make it clear that compensation arrangements between an independent contractor and a service recipient that involve the provision of management services (including certain investment advisory services) are not excluded from coverage under 409A.

Definition of Nonqualified Deferred Compensation

- **In General:** Continuing the guidance provided in Notice 2005-1, the Proposed Regulations provide that a plan provides for the deferral of compensation if, under the terms of the plan and the relevant facts and circumstances the service provider has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is payable to the service provider in a later year. Notice 2005-1 also provided that a service provider does not have a legally binding right to compensation if the compensation could be unilaterally reduced or eliminated unless the facts and circumstances indicated that it was unlikely that the discretion would be exercised. The Proposed Regulations provide more clarity by providing that negative discretion will be recognized (thus avoiding the existence of deferred compensation) unless it lacks “substantive significance” or is exercisable only upon the occurrence of a condition. Also, the negative discretion will be ignored (and the service provider will be treated as having a legally binding right to the compensation) where the service provider has control over, or is related to, the person granted the discretion to reduce or eliminate the compensation, or has control over all or any portion of such person’s compensation or benefits.
- **Short-Term Deferrals:** The Proposed Regulations continue the short-term deferral exception set forth in Notice 2005-1, Q&A-4. Very importantly, however, the Proposed Regulations make it clear that an arrangement will not fail to qualify for the short-term deferral exception because it does not *require in all cases* that amounts will be paid within the deadline as long as, in fact, the amounts are paid by such deadline. However, including the deadline in the agreement can provide a safety net if it turns out the payment is not made by the deadline for the short-term deferral exception. Under the new rules that permit additional delay in payment for 409A-covered arrangements (discussed in more detail below), it may still be possible for an arrangement that misses the short-term deferral exception to comply with 409A, if it contains a payment date.
- **Stock Options and Stock Appreciation Rights (SARs) – In General:** The Proposed Regulations broaden the rules for SARs that are exempt from 409A to make them comparable to the rules Notice 2005-1 applied to 409A exempt stock options. Thus, SARs and options on a service recipient’s eligible stock will be exempt if the exercise price is no less than the fair market value of the stock at grant (even if the SAR is settled in cash or is based on private company stock). To address potential abuse, the Proposed Regulations add new rules on what is eligible service recipient stock.
- **Stock Options and SARs - Service Recipient Stock:** First the good news. Service recipient stock now includes stock of entities that would be combined with the service recipient based on a 50% (rather than 80%) affiliation standard (applying the rules of section 414(b) and (c)). The 50% threshold may be reduced as low as 20% if legitimate business criteria apply and if the service recipient elects such lower percentage to be applied consistently to all stock rights. In addition, service recipient stock also includes ADRs and may include mutual company units. With respect to the “bad” news, service recipient stock does not include stock with preferences as to dividends or liquidation rights and will only include the class of *common* stock that as of the date of grant has the highest aggregate value of any class of common stock of the corporation outstanding (or a substantially similar class, ignoring differences in voting rights). Service recipient stock also does not include stock that is subject to a mandatory repurchase obligation or a put or call right that is based on a measure other than the fair market value of the stock. The Proposed Regulations, do provide, however, that any class of *common* stock of the service recipient with respect to which stock rights were granted on or before December 31, 2004, will be treated as service recipient stock. Grants made in 2005, however, are not protected. Companies with outstanding options to purchase stock that does not qualify as service recipient stock will need to take revise the options to avoid violating 409A.

INNOVATION IN ACTION: PROACTIVE UPDATES ON CRITICAL ISSUES AND CHANGES IN THE LAWS AFFECTING YOUR BUSINESS

- **Stock Options and SARs - Valuation of Service Recipient Stock:** The Proposed Regulations provide some flexibility in determining the fair market value of service recipient stock. For stock readily tradable on an established securities market, fair market value may be determined based upon an actual transaction on the grant date or immediately before or after the grant date or based upon average selling prices during a specified period within 30 days before or 30 days after the grant as long as the commitment to grant the stock is irrevocable before the beginning of the period and the valuation method is used consistently. For stock not readily tradable on an established securities market, the Proposed Regulations allow the reasonable application of a reasonable valuation method. The Proposed Regulations also set forth factors to be considered under a reasonable valuation method, provide presumptions regarding appraisals that follow the ESOP valuation rules, and provide special rules for valuing illiquid stock of start-up corporations (these are less demanding than the ESOP rules, but often more demanding than current practice).
- **Stock Options and SARs - Modifications:** Any modification of a stock right other than an extension or renewal of the stock right is considered the grant of a new stock right. To be exempt from 409A, the new stock right would need to have an exercise price that is no less than the fair market value of the stock on the new grant date. The Proposed Regulations contain additional detail regarding changes that will constitute a modification and changes that will not constitute a modification. The Proposed Regulations also provide special rules relating to corporate transactions and the permissible adjustment of options to reflect such corporate transactions.
- **Stock Options and SARs - Extensions and Renewals:** Generally, any extension or renewal of a stock right will cause such stock right to be treated as having had an additional deferral feature from the date of grant, and, therefore, the stock right will be subject to 409A. The Proposed Regulations contain a limited exception, however, for an extension of the exercise period to a date no later than the later of the 15th day of the third month following the date at which, or December 31 of the calendar year in which, the stock right would otherwise have expired if the stock right had not been extended.
- **Separation Pay Arrangements:** Many comments suggested that severance plans should be exempt from 409A, but the Preamble states that 409A was not meant to be applied narrowly and that some severance plans should be subject to 409A. Severance plans are referred to in the Proposed Regulations as “separation pay arrangements” to avoid confusion with other Code provisions (such as section 457(e)(11) and section 3121(v)(2)). The Proposed Regulations provide several clarifications with respect to separation pay arrangements.
 - **Two Times Compensation/\$420,000 Exemption:** A separation pay arrangement is exempt from 409A if (i) the total of all payments to a service provider do not exceed two times the service provider’s annual compensation for the year prior to termination (or, if less, two times the section 401(a)(17) limit on compensation that may be considered for qualified plan purposes) and (ii) all payments will be made by the end of the second calendar year following the year in which the service provider terminates employment.
 - **Availability of Short-Term Deferral Exception:** Separation pay that is payable only upon an involuntary termination of employment is generally not vested until termination of employment; therefore, the arrangement can be structured to be exempt from 409A by complying with the short-term deferral exception. This is generally not true if benefits are paid upon a voluntary termination for “good reason,” although comments have been requested. Voluntary participation in a window program will be treated as an involuntary separation from service that could qualify for a separation pay exemption from 409A.
 - **Reimbursement of Expenses:** Employees are often entitled to reimbursement of certain business expenses. Generally, such reimbursement is contingent upon continued employment, so the reimbursements would not be considered deferred compensation. If the reimbursements continue as part of a severance arrangement, however, such amounts could be subject to 409A. The Proposed Regulations provide a limited exemption for reimbursement arrangements in connection with a termination of employment that cover amounts that are

INNOVATION IN ACTION: PROACTIVE UPDATES ON CRITICAL ISSUES AND CHANGES IN THE LAWS AFFECTING YOUR BUSINESS

otherwise excludible from gross income such as business expenses, outplacement services, moving expenses, or medical payments, as well as other payments that do not exceed \$5,000 in the aggregate during any taxable year, as long as all amounts reimbursed are incurred and reimbursed by the end of the second calendar year following the calendar year in which the service provider terminates. *The surprising implication of this exemption is that reimbursements occurring after the two-year period of amounts that would otherwise not be includible in income may be subject to 409A.* There had been informal suggestions from the government that excludible income would never be covered by 409A.

- **Split-Dollar Life Insurance Arrangements:** Some, but not all, split-dollar life insurance arrangements are identified as exempt from 409A, *i.e.*, death-benefit-only arrangements, arrangements structured as loans (unless there is a binding promise to forgive the indebtedness or to charge below-market interest). Comments are requested with regard to relief that may be needed to allow covered split-dollar arrangements that were entered into before 12/17/2003 to remain grandfathered while being revised to comply with 409A.

Plan Aggregation and Splitting

- **In General:** With respect to combining plans of the same type (*i.e.*, account balance, non-account balance and equity) and splitting-up plans by covered individual, the Proposed Regulations generally retain the rules in Notice 2005-1, but separation pay plans are now their own separate type of plan.

Definition of Substantial Risk of Forfeiture

- **In General:** The Proposed Regulations adopt the definition set out in Notice 2005-1. Compensation is subject to a substantial risk of forfeiture if (i) it is conditioned on the performance of substantial future services or the occurrence of a condition related to the compensation, *and* (ii) the possibility of forfeiture is substantial. A stock right will be treated as not subject to a substantial risk of forfeiture after the first date the holder may exercise the right and receive cash or substantially vested property. In determining whether the risk of forfeiture is real, close scrutiny will be applied when the participant owns a significant share of the total voting power or value of a company's stock.
- **Ineffective Provisions:** Adding a forfeiture provision after a legally binding right to the amount arises and "rolling" a risk of forfeiture will be disregarded in determining whether a substantial risk of forfeiture exists. In addition, an amount is not subject to a substantial risk of forfeiture just because the right to the amount is conditioned upon *refraining* from performance of services (*e.g.*, a noncompete restriction).

Initial Deferral Election Rules

- **In General:** Generally, a service provider may elect to defer compensation for services performed in a tax year of the service provider only if the election is made by the close of the preceding tax year. For this purpose, a deferral election includes both an election as to the time of payment and the form of payment. An election is deemed made at the time it becomes irrevocable; thus, a plan may permit election changes so long as the election becomes irrevocable by the deadline. The Preamble confirms that elections that roll over from year to year unless affirmatively changed by the service provider ("evergreen" elections) are permissible, so long as the election for each year becomes irrevocable by the applicable deadline.
- **Nonelective Plans:** A nonelective plan must set the time and form of payment no later than the date the service provider obtains a legally binding right to the compensation; ongoing discretion in this regard is impermissible.
- **Performance-Based Compensation:** 409A permits initial deferral elections to be made for "performance-based compensation" as late as six months prior to the end of the performance period. The definition that appeared in Notice 2005-1 for "bonus compensation" is now the generally applicable definition, with a few enhancements.

INNOVATION IN ACTION: PROACTIVE UPDATES ON CRITICAL ISSUES AND CHANGES IN THE LAWS AFFECTING YOUR BUSINESS

However, some employees hired during a year still will not be able to use the later deferral election deadline for performance-based compensation.

- **What is Performance-Based Compensation:** “Performance-based compensation” is compensation where the right to payment or the amount of payment is contingent on the satisfaction of pre-established organizational or individual performance criteria relating to a *performance period* of at least 12 consecutive months and that are not substantially certain to be met at the time of the deferral election. Subjective criteria are permitted if they relate to the service provider or a work group or organization to which the service provider belongs. As enhancements to Notice 2005-1, the Proposed Regulations provide that the criteria must be established in writing not later than 90 days *after* the performance period begins and that compensation can be performance-based if it is based solely on an increase in the value of the service recipient, or stock of the service recipient, after the award date. However, equity based compensation that is not solely based on an increase in the value of recipient stock will qualify as performance-based if it is subject to a condition that would cause the award to otherwise qualify as performance-based.
- **Service Requirement:** Both the statute and Notice 2005-1 required that the performance-based compensation be “based on services performed over a period of at least 12 months.” For annual bonuses, this rule denied use of the later election deadline for performance-based compensation to those who were hired after the start of the annual bonus service period. It also appeared to disqualify a later performance-based election with respect to those who terminated before the end of the year. However, as noted above, the Proposed Regulations require that performance-based compensation be “based upon a *performance period* of at least 12 months.” Regarding the period of required service, the Proposed Regulations only require continuous service from when the performance criteria are set to when the election is made (i.e., when it becomes irrevocable). Because performance criteria can be set as late as 90 days into the performance period, some of those hired after the beginning of a year can use the later election deadline for performance-based compensation, and service through year end is not required.
- **Initial Year of Eligibility:** A service provider may make an initial deferral election within the first 30 days after he first becomes eligible to participate in a plan, so long as the election applies only to services performed after the election. To determine the amount that may be deferred, the Proposed Regulations call for prorating compensation earned over a period that has already begun at the time of a newly-eligible service provider’s deferral election. In that case, the election may apply to a portion of the compensation that is not greater than the total amount multiplied by the ratio of the number of days remaining in the performance period after the election over the total number of days in the performance period. The Preamble confirms that plan aggregation rules apply for purposes of the newly-eligible service provider rule. However, as discussed below, this result is ameliorated by the fact that the Proposed Regulations create a separate 30-day election period for the mid-year grant of a forfeitable award. Treasury and the IRS have requested comments as to whether further relief is needed in this area.
- **Short-Term Deferrals:** Compensation that qualifies for the short-term deferral exception can still be deferred electively, thereby taking it out of the exception. (Note: The requirement under Notice 2005-1 that the compensation had to be paid at all times within 2-1/2 months was an impediment to deferrals in these cases that no longer exists.) When an initial election has not been made (e.g., when the service provider does not use the rule for certain forfeitable rights below), the Proposed Regulations include rules that facilitate using a subsequent (or “redeferral”) election as the means of accomplishing the deferral. Specifically, the date the risk of forfeiture lapses (i.e., the vesting date) is treated as the original payment date, and the original form of payment is the form applicable in the absence of a deferral election. The redeferral election must be made at least 12 months before the vesting date, and payment must be delayed at least five years from the vesting date.

INNOVATION IN ACTION: PROACTIVE UPDATES ON CRITICAL ISSUES AND CHANGES IN THE LAWS AFFECTING YOUR BUSINESS

- **Certain Forfeitable Rights:** The Proposed Regulations include a new rule for mid-year grants of awards subject to forfeiture conditions requiring more than 12 months of service. In this case, the initial deferral election may be made no later than 30 days after the grant date, so long as the election is made at least 12 months before the end of the service period. This rule allows a true initial election with respect to a compensation award that comes within the short-term deferral exception, but apparently only if the basis for the award's substantial risk of forfeiture is a *service* condition of at least 12 months.
- **Severance Pay Under Ad Hoc Arrangements:** If separation pay becomes payable upon an involuntary termination and the service provider and recipient engage in bona fide, arm's length negotiations to determine the separation pay, the service provider can make an election as to the form and time of payment anytime on or before the date the service provider obtains a legally binding right to the payment. This will allow payment flexibility for ad hoc arrangements that are negotiated just in advance of termination.
- **Fiscal Year Compensation:** The initial election to defer fiscal year compensation must be made no later than the end of the prior fiscal year. To qualify as fiscal year compensation for this purpose, the compensation must specifically be based on the service recipient's fiscal year as the measurement period. This rule is available for bonuses determined on a fiscal year, *but not for salary*.
- **Commissions:** A service provider is treated as having performed the services giving rise to payments that qualify as "commissions" during the year in which the customer makes payment for the related good or services.

Time and Form of Payment

- **Some Additional Delay in Payment Permitted:** The Proposed Regulations generally reflect the statutory requirements regarding permissible payment dates while incorporating significant administrative flexibility. For example, when payment is based on a specified event, the plan must designate an objectively determinable date *or year* following the event upon which the payment is to be made. *Payment will be treated as made on a specified date if the payment is made by the end of the calendar year containing the specified date or, if later, by the 15th day of the 3rd calendar month following the specified date.*
- **Specified Time or Event and Vesting as a New 409A Event:** If a plan specifies just the calendar year in which payment must be made (rather than a specific payment date), the payment is deemed to be scheduled for January 1 of such calendar year for purposes of applying the subsequent deferral rules. A plan will properly provide for payment at a specified time or pursuant to a fixed schedule if it provides at the time of deferral that the payment will be made on an objectively determinable date based upon the vesting date for the compensation, disregarding any vesting acceleration other than on account of death or disability. *Thus, the date when a substantial risk of forfeiture lapses now qualifies as additional payment date.* This adds important flexibility for plan design.
- **Separation from Service – In General and New Safe Harbors:** An employee experiences a separation from service when he dies, retires or otherwise has a termination of employment. The employment relationship continues during a bona fide leave of absence that does not exceed 6 months, or longer if the right to reemployment is protected by statute or contract. For independent contractors, the definition of severance from service is based on the definition of severance from employment in the Section 457 regulations. To prevent employment from being artificially extended or shortened, the Proposed Regulations provide for determining whether a termination of employment has occurred based on all the facts and circumstances. If the employee and employer only *intend* for the employee to provide insignificant services, employment will not be considered continued. Under a safe harbor, if the annual level of services and pay are at least 20% of average prior levels (looking at the last three full calendar years, or the actual employment period if shorter), significant services are considered to be intended. On the other hand, if an employee switches to consultant status, employment will be deemed to continue if annual pay and services are at least 50% of prior levels.

INNOVATION IN ACTION: PROACTIVE UPDATES ON CRITICAL ISSUES AND CHANGES IN THE LAWS AFFECTING YOUR BUSINESS

- **Six Month Delay for Key Employees:** Service recipients may specify a 12-month period during which key employees will be identified. Individuals who meet the Section 416 definition of key employee during the specified period will be treated as key employees subject to the 6-month delay. This delay applies to these key employees for the 12-month period that begins on the 1st day of the 4th month following the end of the 12-month identification period. A plan may provide that any payment that comes due within the 6-month period for a key employee may be delayed until the end of the 6-month period or that each scheduled payment that becomes payable on account of separation from service is delayed 6 months (or a combination of these may be specified). A plan may be amended to specify or change the manner of accommodating the 6-month delay, so long as the amendment does not become effective for at least 12 months. However, for an entity that first becomes a publicly-traded corporation, such an amendment may be effective immediately.
- **Death or Disability:** The Proposed Regulations reflect the definition of disability set out in the statute. However, it is also permissible to define “disability” with deference to Social Security Administration disability determinations. In addition, *a plan need not provide for payment upon all events that would qualify as disabilities*, as long as the definition is never too liberal. This can allow the use of definitions that are easier to administer.
- **Change in Control:** The Proposed Regulations generally incorporate the change in control provisions from Notice 2005-1, which pertain only to corporations. The Preamble states that Treasury and the IRS intend to issue regulations extending these rules to partnerships and that until such regulations are issued, the existing rules for corporations may be applied by analogy to partnerships. Relief has not been provided for other non-corporate entities, but Treasury and IRS have requested comments in this regard. “Earn out” arrangements in corporate transactions will meet the requirements of 409A so long as the payment schedule for equity-based compensation arrangements is the same as that applicable to shareholders generally.
- **Unforeseeable Emergency:** Generally medical, casualty and funeral expenses can qualify, while college tuition and home purchases cannot. Emergencies that can be relieved from other sources do not qualify. The distribution must be limited to the amount reasonably necessary to satisfy the emergency need, which *may* include taxes and penalties and *must* include amounts available by canceling future deferrals, if plan terms permit cancellation of deferrals for an emergency. A plan need not make distributions for all 409A emergencies, as long as all emergencies that trigger distributions meet the requirements of 409A.
- **Flexibility Through Multiple Payment Events:** A plan may provide for payment at the earlier of, or later of, two or more permissible events or times, and a different form of payment may be elected for each potential payment event.
- **Delay in Payment by Service Recipient for Legal Compliance Reasons:** A plan may provide for delaying payment to avoid (i) the loss of deductions under section 162(m), (ii) making payments that violate securities laws (or other applicable laws), and (iii) making payments that violate loan covenants or other contractual terms (if the violation would cause material harm to the service recipient). In general, only the minimum delay necessary is permitted. Thus, a payment delayed pursuant to section 162(m) must be paid out in the first year the service recipient reasonably anticipates it will not result in a loss of deduction, but not later than the calendar year in which the service provider separates from service. The phrasing of the Proposed Regulations implies that partial payments are not required if part (but not all) of the payment could be made without violating section 162(m). A plan may be amended to add these restrictions, but the amendment cannot be effective for 12 months. Removing these restrictions from a plan is a prohibited acceleration. If payment is delayed by a dispute or a refusal by the service recipient to pay, payment will be deemed made timely if the service provider acts in good faith and makes prompt and reasonable, good faith efforts to collect. Once the payment issues are finally resolved, payment must

INNOVATION IN ACTION: PROACTIVE UPDATES ON CRITICAL ISSUES AND CHANGES IN THE LAWS AFFECTING YOUR BUSINESS

be made by the end of the calendar year of resolution. The Preamble cautions that this provision does not permit delay through feigned disputes or collusion, which generally will trigger a violation of 409A.

Anti-Acceleration Rule

- **Permissible Plan Terminations:** The Proposed Regulations provide three circumstances under which a plan may be terminated at the discretion of the service recipient in accordance with the terms of the plan. First, a plan may be terminated if the service recipient determines it wants to cease to provide a specific category of deferred compensation (such as all nonaccount balance plans, or all separation pay plans), the service recipient terminates all arrangements of the same type with respect to all participants, no payments other than those payable under the terms of the plan absent a termination of the plan are made within 12 months of the termination of the arrangement, all payments are made within 24 months of the termination of the arrangement, and the service recipient does not adopt a new arrangement of the same type at any time for a period of five years following the date of termination of the arrangement. Second, a plan may be terminated during the 12 months following a change in control of a corporation. Finally, a plan may provide that it will terminate upon a corporate dissolution or with approval of a bankruptcy court as long as certain requirements are met.
- **Termination of Deferral Elections Following an Unforeseeable Emergency:** A plan may provide for the termination of deferral elections following emergency distributions from a deferral plan *or* if required to obtain a hardship distribution from a qualified 401(k) plan.

Subsequent Changes in Time and Form of Payment

- **In General:** The Proposed Regulations provide that any subsequent election to delay payment or to change the form of payment (i) may not take effect until at least 12 months after the date on which the subsequent election is made, (ii) must defer the first payment for at least five years from the date the payment would have otherwise been made (the “5-year rule”), and (iii) may not be made less than 12 months prior to the date of the first scheduled payment.
- **Definition of Payment – One Payment or More Than One:** The Proposed Regulations clarify how to apply the subsequent election rules to multiple payments and streams of payments such as installment payments and annuities. Generally, each payment that is separately identified is eligible for a separate subsequent election.
 - **Installments:** Installments are generally treated as a single payment (occurring on the date of the first installment), but a plan may provide for treating each individual installment as a separate payment (if it does so at all times with respect to a deferral). Under the first approach, a set of installments could be switched to a lump sum that is payable five years after the first installment payment. However, under the latter approach, switching to a lump sum would require delaying payment until five years after when the last installment would have been paid. For deferral arrangements in effect by 12/31/2006, the Proposed Regulations allow until that date for installments to be designated in writing as separate payments.
 - **Annuities:** Life annuities, on the other hand, must always be treated as a single payment. Thus, a life annuity commencing January 1, 2010 could be replaced with a lump sum payment payable on January 1, 2015 without being considered an impermissible acceleration of some of the annuity payments. Note: This rule treating annuities as a single payment also provides the basis for implementing the legislative history that authorized late elections with respect to actuarial equivalent annuities (*i.e.*, without regard to the normal restrictions that apply to redeferral elections). Under the Proposed Regulations, a choice is permitted between actuarial equivalent annuities if the election is made before any annuity payment has been made.

Nonqualified Plans Linked to Qualified Plans

- **Limited Impact from Qualified Plan Changes Permitted:** For nonqualified plans that are linked to qualified plans, *e.g.*, make-up, wrap and spillover plans, the Proposed Regulations generally permit amendments and elections with respect to the qualified plan to impact the nonqualified plan without violating 409A. Changes in the benefits under the nonqualified plan generally must be limited to the overlap between the nonqualified and qualified plans.
- **401(k) Sweep Plans Permissible:** The Proposed Regulations contain an example that makes clear that if amounts are initially deferred under a nonqualified plan followed by a transfer from the nonqualified plan to the qualified plan of the maximum amount eligible for deferral under the qualified plan as soon as administratively practical after the end of the relevant plan year, the transfer does not constitute an impermissible payment acceleration.

Statutory Effective Dates

- **General Effective Date:** Consistent with Notice 2005-1, the Proposed Regulations confirm that 409A applies to amounts deferred after December 31, 2004 and to amounts deferred earlier if the plan under which the deferral occurred is “materially modified” after October 3, 2004.
- **Date of Deferral:** Consistent with Notice 2005-1, in applying the effective date, an amount is considered deferred as of the date (i) the service provider has a legally binding right to be paid the amount, *and* (ii) the right to the amount is earned and vested. The right to an amount is not earned and vested if it is subject to a substantial risk of forfeiture, as defined under *Section 83* (not under the special definition outlined above), or a requirement to perform additional services. Treasury and IRS declined to provide a blanket exemption for contractual arrangements entered into before the enactment of 409A. A stock option or similar right will be treated as earned and vested by December 31, 2004, if on or before that date it was either immediately exercisable for payment of cash or substantially vested property *or* was not forfeitable.
- **Determining Grandfathered Benefits:** The pre-2005 grandfathered benefit is generally determined pursuant to the rules of Notice 2005-1, as follows:
 - **Account Balance Plans:** The grandfathered amount is the earned and vested account balance as of December 31, 2004, plus any earnings on such amount.
 - **Nonaccount Balance Plans:** The grandfathered amount is the present value as of December 31, 2004 of the earned and vested benefit that would be paid at the earliest possible date if the participant voluntarily separated from service “without cause” as of December 31, 2004. The Proposed Regulations clarify that increases in the present value of the December 31, 2004, benefit that the service provider becomes entitled to pursuant to the October 3, 2004 terms of the plan *without regard* to services performed after December 31, 2004, or other events affecting the amount of or the entitlement to benefits are also grandfathered (such as a plan subsidy to which the service provider later becomes entitled that is not based on post-2004 service).
 - **Equity-Based Compensation Plans:** The grandfathered amount is the payment that would have been available if the right had been exercised on December 31, 2004, plus any earnings (which includes any increase in the payment due to stock appreciation).
 - **Separation Pay Plans:** The rules applicable to account balance or nonaccount balance plans will apply, depending on the structure of the severance pay plan at hand.
- **Material Modifications:** In general, a material modification occurs if a benefit or right as of October 3, 2004 is materially enhanced or a material new benefit or right is added, and such enhancement or addition affects amounts

INNOVATION IN ACTION: PROACTIVE UPDATES ON CRITICAL ISSUES AND CHANGES IN THE LAWS AFFECTING YOUR BUSINESS

earned and vested prior to January 1, 2005. Accelerating vesting, to increase the vested December 31, 2004 benefit, is a material modification. In addition, while amending a plan to comply with 409A is not generally a material modification, adding a new benefit for pre-2005 deferrals is a material modification even if it is benefit that is permitted under 409A, such as adding distributions for an unforeseeable emergency. An amendment to stop future deferrals is not a material modification. The special rule aggregating plans does not apply in determining material modifications, which should help contain the impact of a material modification. *The Proposed Regulations provide a helpful exception for inadvertent modifications:* if a modification is rescinded before the earlier of the date any additional right granted under the modification is exercised or the end of the calendar year in which the modification was made, the modification will not be treated as a material modification. Interest earnings that are not tied to an actual investment may be changed provided the rate is a reasonable interest rate. Rules patterned after those in the section 3121(v) regulations allow a rate reset to a reasonable rate at least every five years to be considered reasonable.

Matters Not Covered

- **Calculation and Timing of Income Inclusion Amounts:** Treasury and IRS intend to address these subjects in future guidance and have requested comments, specifically on two subjects: (i) whether and how negative earnings should be accounted for in determining the amount of deferrals and the amount of income inclusion, and (ii) the transition relief that should be provided once the method has been determined for calculating current deferrals and the amounts to be included in income for purposes of service recipient tax reporting and withholding.
- **Funding Arrangements:** This subject will also be addressed in subsequent guidance. Treasury and the IRS note that the definition of “deferred compensation” set out in the Proposed Regulations may answer or at least minimize the open questions relating to foreign arrangements and funding.

The information contained in this *Legal Alert* is not intended as legal advice or as an opinion on specific facts. For more information about these issues, please contact Mark Wincek in the Washington office (202) 508-5800, Jennifer Schumacher and Bill Vesely in the Atlanta office (404) 815-6500, Lois Colbert in the Raleigh office (919) 420-1700, or Bill Wright in the Winston-Salem office (336) 607-7300. The invitation to contact these individuals is not to be construed as a solicitation for legal work in any jurisdiction in which the individuals are not admitted to practice. There will be no charge for the initial contact. Any attorney/client relationship will be confirmed in writing. You can also contact us through our Web site at www.kilpatrickstockton.com