WHAT EVERY ESTATE PLANNER NEEDS TO KNOW ABOUT 409A FINAL REGULATIONS

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TABLE OF CONTENTS

Page

I. SCOPE AND BACKGROUND 1

II. AN OVERVIEW OF SECTION 409A 2

A. BACKGROUND 2

1. Before 409A 2
2. American Jobs Creation Act 2
3. Notice 2005-1 Guidance 3
4. Proposed Regulations 3
5. Additional Legislation and Guidance 3
6. Final Regulations 4

B. A THUMBNAIL SKETCH OF 409A AND FINAL REGULATIONS 4

1. Expansion of Constructive Receipt Rules 4
2. Expansion of the Funding Rules of Section 83 5
3. Plans Excluded From 409A 5
4. What Is a Covered Nonqualified Deferred Compensation Plan? 6
5. What Constitutes Deferred Compensation? 6
6. Items Excluded From Deferred Compensation By Final Regulations 6
7. Important Definitions 8
8. Violations of Section 409A – Income Inclusion, Penalty Tax and Interest 9
9. Effective Date and Grandfathering Rules 10
10. Transition Rules Through December 31, 2007 10

III. DEFINITIONS OF DEFERRED COMPENSATION AND PLAN ARE VERY BROAD 11

A. WHAT IS A NONQUALIFIED DEFERRED COMPENSATION PLAN UNDER SECTION 409A? 11

1. Statutory Definition 11
2. Final Regulation Definition 12
3. Plans Excluded From 409A By Statute 13
4. Plans Excluded From 409A by Regulation 15

B. WHAT CONSTITUTES DEFERRED COMPENSATION UNDER SECTION 409A? 17

1. Statutory Definition 17
2. Final Regulation Definition 17

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TABLE OF CONTENTS
(continued)

Page

3. Items Excluded From Deferred Compensation By Regulation 19

IV. WATCH OUT FOR THE PLAN AGGREGATION RULES 33

A. HOW SECTION 409A APPLIES TO DEFERRED COMPENSATION PLANS 33

1. Participant By Participant 33
2. Service Recipient By Service Recipient 33

B. SERVICE PROVIDER AND PLAN AGGREGATION RULES 34

1. General Concepts 34
2. Service Provider Aggregation Groups. 34
3. Impact of Plan Aggregation Rules 35
4. Areas Not Subject To Plan Aggregation Rule 36

V. AVOID 409A PROBLEMS BY USING THE SHORT TERM DEFERRAL EXCEPTION 37

A. GENERAL RULE 37

B. SPECIFICS OF THE GENERAL RULE 37

1. What Is a Deferred Payment? 37
2. Application to Life Annuity and Installment Payments 38
3. When is a Right to Payment Vested for the Short Term Deferral Exclusion? 38
4. Typical Application of Short Term Deferral Rule 39

C. EXCEPTIONS TO THE TWO AND A HALF MONTH APPLICABLE PERIOD 39

1. Administratively Impracticable 39
2. Jeopardize Going Concern 39
3. Nondeductible Under 162(m) 39

D. SHOULD THE SHORT TERM DEFERRAL EXCLUSION BE WRITTEN INTO THE PLAN? 40

VI. JUST HOW DO THOSE SEPARATION PAY EXCLUSION RULES WORK? 40

A. GENERAL 40

B. COLLECTIVELY BARGAINED SEPARATION PAY PLANS 40

C. NON-COLLECTIVELY BARGAINED SEPARATION PAY ARRANGEMENTS 41

D. FOREIGN SEPARATION PAY PLANS 41

TABLE OF CONTENTS
(continued)

Page

E. REIMBURSEMENTS AND CERTAIN OTHER SEPARATION PAYMENTS 41

1. General Reimbursements 41
2. Medical Benefits 42
3. In-Kind Benefits and Direct Service Recipient Payments 42

F. DEFINITIONS 42

1. Window Programs 42
2. Involuntary Separation From Service 42

G. MISCELLANEOUS CONSIDERATIONS 44

1. When Severance Pay is Subject to Section 409A 44
2. Severance Pay Exclusions Can Be Used In Combination 44
3. Severance Pay Cannot Be Used As a Deferred Compensation Substitute 44
4. Short Term Deferral May Apply 44
5. Impact Upon Six Month Delay For Specified Employees 44
6. Separation Pay that Overlaps Ceiling 44

VII. IT IS OK TO DISTRIBUTE AFTER “SEPARATION FROM SERVICE” . . . WAIT A MINUTE, IT’S NOT THAT SIMPLE!! 45

A. SEPARATION FROM SERVICE 45

1. Statutory General Rule 45
2. What Is Separation From Service For An Employee? 45
3. What Is Separation From Service For An Independent Contractor? 46

B. SPECIFIED EMPLOYEE AND SIX MONTH DELAY 47

1. Definition 47
2. Compensation of Specified Employee for Definition Purposes 47
3. Specified Employee Identification Date 47
4. Specified Employee Effective Date 47
5. Alternative Methods of Identifying Specified Employees 48
6. Corporate Transactions 48
7. Nonresident Alien Specified Employees 48
8. How is the Six Month Delay for Specified Employees Accomplished? 48

VIII. HOW DO I INITIALLY DEFER COMPENSATION UNDER THE NEW RULES 49

A. DEFER TIME AND FORM OF PAYMENT 49

TABLE OF CONTENTS
(continued)

Page

B. DATE OF INITIAL DEFERRAL BY SERVICE PROVIDER 49
  1. Prior Year Election 49
  2. Thirty Days After Eligibility 49
  3. Performance Based Compensation 50
  4. Special Initial Deferral Rules 51

C. INITIAL DEFERRAL ELECTION FOR NON-ELECTIVE DEFERRED COMPENSATION 51

IX. I DEFERRED BUT WANT TO REDEFER—HOW? 52

A. REDEFERRAL ELECTIONS TO CHANGE TIME AND FORM OF PAYMENTS 52
  1. Conditions For Redeferral 52
  2. Definition of Payments For Purposes of Subsequent Changes in Time or Form of Payment 52
  3. Beneficiaries 53
  4. Domestic Relations Orders 53
  5. Coordination of Deferrals With Prohibition Against Acceleration of Payments. 53
  6. Application of Deferral Rules From Multiple Payment Events 53

B. EXCEPTIONS TO REDEFERRAL RULES 54
  1. Delay of Payments Under Certain Circumstances Which Do Not Require the Redeferral Rules to be Met 54
  2. USERRA 54

X. TO WHAT EXTENT ARE MY OLD PLANS GRANDFATHERED? 55

A. EFFECTIVE DATE AND GRANDFATHERING RULES 55
  1. When Did Section 409A Become Effective? 55
  2. Grandfathered Deferrals 55

B. MATERIAL MODIFICATION EXCEPTION TO GRANDFATHERING 57
  1. When Is A Plan Materially Modified? 57
  2. Modifications Which Are Not Material 57
  3. Adoption of a New Arrangement 58
  4. Suspension or Termination of Plan 58
  5. Rescissions of Modifications 59
  6. No Plan Aggregation 59

TABLE OF CONTENTS
(continued)

Page

XI. WHAT SHOULD I DO NOW BEFORE 2008? ... 59

1. Determine What Plans Provide Deferred Compensation ... 59
2. Identify Grandfathered Deferred Compensation and (Perhaps) Preserve Grandfathering ... 59
3. Performance-Based Compensation Elections ... 59
4. Good Faith Operational Compliance ... 60
5. Determine Whether Special Transition Rules Should Be Adopted ... 60
6. Make Amendments To Take Advantage of Short Term Deferral Rule ... 60
7. Unlink Payments of 401(k) Wraparound and Excess Benefit Plans ... 60
8. Adopt the Amendments No Later Than December, 31, 2007 ... 60
9. Employee Consent ... 61

WHAT EVERY ESTATE PLANNER NEEDS TO KNOW ABOUT 409A FINAL REGULATIONS

By Donald O. Jansen, J.D., LL.M.

I. SCOPE AND BACKGROUND

Although Section 409A has been on the books since January 1, 2005, the newly issued final regulations are effective January 1, 2008. Between now and the end of 2007, all nonqualified deferred compensation plans must be amended to either qualify for an exclusion from the terms of Section 409A or meet the requirements of Section 409A. Failure to amend the plan during this transition rule could result in immediate taxation of "deferred" compensation with an additional twenty percent penalty tax for the unwary. The new Code section and final regulations impose significant new restrictions on all forms of nonqualified deferred compensation.

Your initial reaction may be that I am an estate planner and not an employee benefits specialist. Why should I be concerned about the provisions of this new statute and final regulations? The answer to that question is that significant numbers of your clients may be impacted by the new statute. Although you do not have to become conversant in all aspects of the statute and regulations, it is important that you become familiar with the general principles so that you can advise your clients and direct them to experts in the field if necessary.

Two categories of clients who will be impacted by the new law include closely held business owners and executives of publicly traded or private corporations.

Closely held business owners typically are underpaid and plow all the funds of the business back into its growth and development. If the ownership of the business is to pass on to the next generation, these owners are quite interested in having a current deferred compensation contract which will allow the business to continue to pay all or part of their salaries after their retirement in a manner which will be deductible to the business under Section 162. Even if the business assets are to be sold to third parties, it could be important to have an existing deferred compensation contract in play so that funds from the sale of the assets of the company can be used to pay deferred compensation to the owner after the sale of the assets.

Many of our clients are key executives of closely held businesses or publicly traded corporations, but are not members of the owning family. Quite often they have all sorts of compensation arrangements which will meet the definition of deferred compensation under Section 409A including stock options, restricted stock units, stock appreciation rights, 401(k) wraparound plans, excess benefit plans, supplemental employee retirement plans, Section 457(f) plans, nonqualified profit sharing plans and severance pay arrangements. All of these could be subject to the restrictions of Section 409A with its broad definition of deferred compensation.

This paper is not intended to go into a detailed review of all of the provisions of Section 409A, the final regulations and other guidance and transition rules issued by the IRS. Instead, it

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will start with an overview of the statute and regulations succeeded by a presentation of the nine following items which estate planners need to know about Section 409A:

1. Definitions of deferred compensation and deferred compensation plan.

2. Plan aggregation rules.

3. Short term deferral exclusion.

4. Separation pay exclusion.

5. Distributions upon separation from service.

6. Initial deferral elections.

7. Redeferral elections.

8. Grandfathering and material modification rules.

9. What should I do now before 2008?

II. AN OVERVIEW OF SECTION 409A

A. BACKGROUND.

1. Before 409A.

Before the new law, income taxation of compensation could be deferred by meeting the requirements of the constructive receipt doctrine and the economic benefit doctrine (and its comrade, Section 83). Under the constructive receipt doctrine of Reg. Section 1.451-2(a), compensation had to be deferred before the employee was entitled to the compensation without substantial limitations or restrictions. Under the judicial economic benefit doctrine and the statutory Section 83 rules, the employer's promise to pay compensation in the future had to be either unfunded and unsecured or non-transferable and subject to a substantial risk of forfeiture to avoid current taxation.

The old doctrines still apply, but Section 409A adds significant new hurdles to overcome in order to protect deferred compensation from taxation.

2. American Jobs Creation Act.

On October 22, 2004, President Bush signed the American Jobs Creation Act. That Act created a new Section 409A of the Internal Revenue Code. The new law constitutes a sea change in the taxation of nonqualified deferred compensation. It is the most significant legislative intervention since Section 83 was enacted in 1969. Section 409A is effective January 1, 2005, and applies to all compensation deferred after 2004.

3. Notice 2005-1 Guidance.

On December 20, 2004, the IRS issued preliminary guidance and transition rules in Notice 2005-1. A revised version of Notice 2005-1 (2005-2 I.R.B. 274, January 10, 2005) was issued on January 5, 2005, which contained two clarifications of the transition rules. Notice 2005-1 gives guidance as to what plans contain deferred compensation, what constitutes deferred compensation, what amounts are subject to substantial risk of forfeitures, change of control rules permitting distributions, the anti-acceleration rule with exceptions, the effective date including grandfathered deferred compensation and material modifications, seven transition rules during 2005 and temporary rules concerning reporting of and withholding from deferred compensation. Notice 2005-1 did not give any guidance concerning the expansion of funding rules under Section 83 and the taxation, interest and additional tax for arrangements which violate Section 409A.

4. Proposed Regulations.

On September 29, 2005, the IRS issued proposed regulations intended to be effective January 1, 2007, which incorporated and expanded the guidance in Notice 2005-1 and implemented many of the other provisions of Section 409A not covered by the Notice. Like Notice 2005-1, the proposed regulations did not include implementation of the calculation and timing of income inclusion amounts under Section 409A nor the funding arrangements under Section 83. The proposed regulations did not discuss the application of Section 409A to partnerships and the split dollar life insurance. The preamble to the proposed regulations extended four of the transition rules through 2006. Public hearings on the proposed regulations were held January 25, 2006.

5. Additional Legislation and Guidance.

a. Notice 2005-94, 2005-2 CB 1208 (transition guidance with respect to 2005 reporting and withholding obligations).

b. Notice 2006-4, 2006-3 I.R.B. 307 (transition guidance valuing stock rights).

c. Notice 2006-33, 2006-15 I.R.B. 754 (transition guidance concerning offshore rabbi trusts and employer health trigger plans).

d. Notice 2006-64, Notice 2006-29 I.R.B. 88 (interim guidance clarifying permissible acceleration of Federal conflict of interest divestiture).

e. Notice 2006-79, 2006-43 I.R.B. 763 (extension of transition rules through 2007).

f. Notice 2007-34 (Application of Section 409A to split dollar insurance arrangements).

g. Notice 2006-100, 2006-51 I.R.B. 1109 (guidance on reporting and withholding obligations).

h. Notice 2007-18 (offering employees a program pursuant to which employee tax obligations for 2006 under non-compliant plans could be satisfied).

i. Congress added a new funding requirement to 409A effective August 17, 2006 in the Pension Protection Act of 2006 (domestic rabbi trusts established or funded during defined benefit plan restricted period. Section 409A(b)(3)).

6. Final Regulations.

The final regulations were issued on April 10, 2007. They are applicable for taxable years beginning on or after January 1, 2008, but taxpayers may rely on the provisions of the final regulations for taxable years beginning before January 1, 2008. The final regulations do not cover the new Section 83 funding rules, partnerships, withholding and reporting and income inclusion, penalty interest and penalty tax rules. These topics will be left to future notices, guidance or regulations.

B. A THUMBNAIL SKETCH OF 409A AND FINAL REGULATIONS.

1. Expansion of Constructive Receipt Rules.

a. Restrictions on Distributions.

A deferred compensation plan must provide that deferred compensation can only be paid upon the occurrence of one or more of the following events: separation from service (or six months after separation for specified (key) employees of public corporations), disability, death, specified time or pursuant to a fixed schedule, change in ownership or effective control of a corporation or partnership, or an unforeseen emergency. Section 409A(a)(2).

b. No Acceleration of Benefits.

The plan must not permit acceleration of the time or schedule of payments under the plan, except as provided in regulations by the Secretary of the Treasury (*e.g.*, hair cut provisions are out). Section 409A(a)(3). The final regulations establish 14 exceptions to this anti-acceleration rule. Furthermore, only acceleration of time or schedule of payments is prohibited, not the acceleration of vesting of deferred compensation. Reg. Section 1.409A-3(j)(4).

c. Restrictions on Deferral and Redeferral Elections.

1) The plan must irrevocably specify the amount, time of payment and form of payment of deferred compensation. Reg. Section 1.409A-2(a).

2) In regard to elective deferrals by the service provider/employee, the initial irrevocable election must be made in the taxable year before services are performed, within 30 days of initial eligibility to participate in the plan or within the first six months of the service year for certain performance-based compensation. Section 409A(a)(4)(B).

3) With regard to non-elective deferrals by the service recipient/employer, the designation of amount, time and form of payment of deferred compensation must be no later than the date the service provider/employee first has a legally binding right to the compensation or, if later, the time the service provider/employee would be required to make such an election if the service provider/employee were provided such an election. Reg. Section 1.409A-2(a)(2).

4) The plan must provide that any elections to redefer or change form of payment must be at least 12 months before the effective date of the change, defer the payment for at least five years (except in the case of disability, death or emergency distributions) and be made no less than 12 months prior to the date of the scheduled payment of the initial deferral. Section 409A(a)(4)(C).

2. Expansion of the Funding Rules of Section 83.

a. Offshore Rabbi Trusts.

Offshore rabbi trusts are treated as transfer of property under Section 83 unless substantially all services supporting the deferred compensation are performed offshore, even though the service recipient/employer's creditors can reach the trust assets. Section 409A(b)(1). Note this does not apply to domestic rabbi trusts.

b. Employer Financial Health Triggers.

There is a taxable transfer of property under Section 83 for any plan which provides for restricted assets upon a change in the employer's financial health. Section 409A(b)(2).

c. Domestic Rabbi Trusts Established or Funded During Restricted Period of a Defined Benefit Plan.

There is a taxable transfer of property under Section 83 for assets set aside or reserved (directly or indirectly) in a trust for an "applicable covered employee" during a "restricted period" for a single-employer defined benefit pension plan of any member of the employer-controlled group. Section 409A(b)(3).

3. Plans Excluded From 409A.

a. Qualified Employer Plans.

These include any plan described in Section 401(a) and a trust exempt from tax under Section 501(a) or that is described in Section 402(d); any annuity plan described in Section 403(a); any annuity contract described in Section 403(b); any simplified employee pension within the meaning of Section 408(k); any simple retirement account within the meaning of Section 408(p); a trust described in Section 501(c)(18); any eligible deferred compensation plan under Section 457(b) – ineligible deferred compensation plans within the meaning of Section 457(f) are subject to 409A; any plan described in Section 415(m); any plan described in Section 1022(i)(2) of ERISA. Section 409A(d)(2). Reg. Section 1.409A-1(a)(2).

b. Welfare Benefit Plan.

These are plans providing bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit, including Archer medical savings accounts described in Section 220, any health savings account described in Section 223, or any other medical reimbursement arrangement, including a health reimbursement arrangement that satisfies the requirements of Section 105 and Section 106 such that the benefits or reimbursements provided under such arrangement are not includable in income Section 409A(d)(1)(B). Reg. Section 1.409A-1(a)(5).

c. Certain Foreign Plans. These are described in Reg. Section 1.409A-1(a)(3).

4. What Is a Covered Nonqualified Deferred Compensation Plan?

Section 409A(d)(1) states that it is "any plan that provides for the deferral of compensation." The final regulations state that it includes any agreement, method, program or other arrangement, including an agreement, method, program or other arrangement that applies to one person or individual. A plan is covered regardless of whether it is adopted unilaterally by the service recipient or negotiated with the service provider or whether it is an employee benefit plan under ERISA. Reg. Section 1.409A-1(c)(1). Certain plan aggregation rules (to be discussed later) are specified in Reg. Section 1.409A-1(c)(2)(i).

5. What Constitutes Deferred Compensation?

A plan provides for the deferral of compensation if, under the terms of the plan and the relevant facts and circumstances, the service provider/employee has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable to (or on behalf of) the service provider in a later taxable year. Deferred compensation includes the earnings on the deferred compensation. Reg. Section 1.409A-1(b)

6. Items Excluded From Deferred Compensation By Final Regulations.

a. Payroll Period Exception. Compensation paid at the end of a normal payroll period which overlaps taxable years is not deferred. Reg. Section 1.409A-1(b)(3).

b. Short Term Deferrals. Reg. Section 1.409A-1(b)(4). There is no deferral of compensation if it is actually or constructively received by the service provider within two and a half months from the end of the later of the service provider's first taxable year or the service recipient's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture.

c. Statutory Stock Options. Reg. Section 1.409A-1(b)(5)(ii). Incentive stock options under Section 422, and employee stock purchase plan options under Section 423 are excluded.

d. Certain Non-Statutory Stock Options. Reg. Section 1.409A-1(b)(5)(i)(A). A non-statutory stock option does not constitute deferred compensation if (a) the exercise price may never be less than fair market value of the underlying stock on the date the option is granted and the number of shares subject to the option is fixed on the original date of grant of the option; (b) the transfer or exercise of the option is subject to taxation under Section 83; and (c) the option does not include any feature for the deferral of compensation other than the deferral or recognition of income until the later of the exercise or disposition of the option or the time the stock acquired by the exercise becomes substantially vested.

e. Certain SARs. Reg. Section 1.409A-1(b)(5)(i)(B). A stock appreciation right ("SAR") does not constitute deferred compensation if (a) compensation payable under the SAR cannot be greater than the excess of the fair market value of the stock (disregarding lapse restrictions) on the date the SAR is exercised over the amount specified on the date of grant of the SAR (the SAR exercise price), with respect to a number of shares fixed on or before the date of grant of the right; (b) the SAR exercise price may never be less than the fair market value of the underlying stock (disregarding lapse restrictions) on the date the right is granted; and (c) the SAR does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the SAR.

f. Restricted Property. Reg. Section 1.409A-1(b)(6). There is no deferral of compensation merely because the value of the property is not includable in income by reason of the property being substantially non-vested or is includable in income solely due to a valid election under Section 83(b). This also includes transfer of a beneficial interest in a trust or annuity plan, or a transfer to or from a trust or under an annuity plan, to the extent such transfer is subject to Section 83, Section 402(b) or Section 402(c).

g. Certain Separation Pay Plans. Certain types of separation (severance) pay arrangements are totally excluded from deferred compensation while others are partially included or totally included by the regulations.

1) Collectively Bargained Plans. Reg. Section 1.409A-1(b)(7)(ii). These are excluded from the definition of deferred compensation to the extent the plan is a collectively bargained separation pay plan that provides for separation pay only upon an involuntary separation from service or pursuant to a window program. The employees must be covered by a bona fide collective bargaining agreement recognized by the Secretary of Labor. The separation pay provision must be the subject of arm's length negotiations between employee representatives and one or more employers and the circumstances must indicate good faith bargaining between adverse parties over the separation pay to be provided under the agreement.

2) Non-Collectively Bargained Separation Pay Arrangements. Reg. Section 1.409A-1(b)(7)(iii). Separation pay is not deferred compensation if paid upon involuntary separation from service or pursuant to a window program if the separation pay does not exceed two times the lesser of the service provider's annual compensation for the preceding taxable year or the maximum amount that is taken into account under a qualified plan pursuant to Section 409(a)(17) for the year in which the service provider has separated from service ($225,000 in 2007). The separation pay must be paid no later than the last day of the second taxable year of the service provider following the taxable year of separation from service.

3) Window Programs. Reg. Section 1.409A-1(b)(7)(vi). Window program refers to a program established by a service recipient to provide separation pay for a limited period of time (no longer than 12 months) to service providers who separate from service during such period of time. The program is not a window program if the service recipient establishes a pattern of repeatedly offering severance pay windows.

4) Separation from Service for Good Reason. Reg. Section 1.409A-1(n)(2). A separation for good reason will be deemed an involuntary separation if prespecified in the plan and if separation is result of material negative change such as duties performed, condition under which duties are to be performed, or compensation to be received for performing such service. Other factors include whether good reason payments are the same amount, time and form as involuntary payments and whether the service provider is required to give notice and the service recipient has reasonable opportunities to remedy. The regulation gives safe harbor conditions demonstrating good reason.

h. Certain Indemnification and Liability Insurance Plans. Reg. Section 1.409A-1(b)(10). A plan does not provide for deferral of compensation to the extent it provides indemnification of, or the purchase of an insurance policy providing for payments of all or part of the expenses incurred or damages paid or payable to a service provider with respect to a bona fide claim against the service provider or service recipient, including amounts paid or payable by the service provider upon the settlement of a bona fide claim where such claim is based on actions and failures to act by the service provider in connection with the service recipient.

i. Legal Settlements. Reg. Section 1.409A-1(b)(11). An agreement to which the service provider is a party does not provide for deferral of compensation to the extent it provides for amounts paid as settlements or awards resolving bona fide legal claims based on wrongful termination, employment discrimination, the FLSA, or worker's compensation statutes, including claims under applicable Federal, state, local or foreign laws, or for reimbursements or payments of reasonable attorney's fees or other reasonable expenses incurred by the service provider related to such bona fide legal claim.

j. Certain Educational Benefits. Reg. Section 1.409A-1(b)(12). A plan in which the service provider participates does not provide for a deferral of compensation to the extent the plan provides for taxable educational benefits.

k. Benefits Otherwise Nontaxable. Reg. Section 1.409A-1(b)(1). Examples include income excludable under Reg. Sections 104, 105, 106, 117, 119, 127, 129 and 132.

7. Important Definitions.

a. Substantial Risk of Forfeiture. Reg. Section 1.409A-1(d).

1) Section 409A invokes substantial risk of forfeiture in two areas:

(a) In applying the short-term deferral exception from nonqualified deferred compensation, the compensation must be included in the employee's or service provider's income within two-and-a-half months after the appropriate taxable year "in which the right to the payment is no longer subject to a substantial risk of forfeiture." Reg. Section 1.409A-1(b)(4)(i).

(b) In addition, even if the amount is deferred compensation under Section 409A, it is not included in income until the taxable year in which it is "not subject to a substantial risk of forfeiture." Section 409A(a)(1)(i).

2) Compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on (i) the performance of substantial future services by any person, or (ii) the occurrence of a condition related to the purpose of the compensation, and the possibility of forfeiture is substantial. The risk of forfeiture cannot be added or extended after the beginning of the service period to which the compensation relates. Unlike Section 83, substantial risk of forfeiture does not include non-competition agreements.

b. Service Provider. Reg. Section 1.409A-1(f). This term includes an individual, corporation, subchapter S corporation, partnership, personal service corporation, non-corporate entity that would be a personal service corporation if it were a corporation, qualified personal service corporation, and non-corporate entity that would be a qualified personal service corporation if it were a corporation, for any taxable year in which such individual or entity accounts for gross income from the performance of services under the cash receipts and disbursements method of accounting. It generally includes a former service provider. Under certain circumstances specified in Reg. Section 1.409A-1(f)(2), an independent contractor can be a service provider.

c. Service Recipient. Reg. Section 1.409A-1(g). Except as specifically provided in the regulation, this term means the person for whom the services are performed and with respect to whom the legally binding right to compensation arises, and all persons with whom such person would be considered a single employer under Section 414(b) or Section 414(c). Solely for the purpose of determining service recipient stock under Section 414(c) for SAR and non-statutory stock option purposes, 50% control is used in lieu of 80% control or, with regard to a joint venture which is based upon legitimate business criteria, 20% control is substituted for 80% control. Reg. Section 1.409A-1(b)(iii)(E).

8. Violations of Section 409A – Income Inclusion, Penalty Tax and Interest.

a. Income Inclusion. Section 409A(a)(1). Section 409A(b)(3). Deferred compensation is included in gross income in the taxable year which includes the later of (a) the nonqualified deferred compensation plan fails to comply with the new constructive receipt or funding rules or is not operated in accordance with those rules; or (b) the deferred compensation is not subject to a substantial risk of forfeiture.

b. Additional Tax. Section 409A(a)(1)(B)(i)(II). Section 409A(b)(4)(A)(ii). An additional 20% income tax is imposed on a deferred compensation included in gross income by the new constructive receipt or funding rules.

c. Interest. Section 409A(a)(1)(B). Section 409A(b)(4). Interest will be included in the gross income for a taxable year in which a tax is imposed because of the new constructive receipt or funding rules. The amount of interest for any taxable year is the underpayment rate plus one percentage point on the underpayments that would have occurred had the deferred compensation been includable in gross income for the taxable year in which first deferred or, if later, the first taxable year in which such deferred compensation is not subject to a substantial risk of forfeiture.

9. Effective Date and Grandfathering Rules.

a. When Did Section 409A Become Effective?

1) The statute applies to (a) amounts deferred in taxable years beginning after December 31, 2004, and (b) amounts deferred in taxable years beginning before January 1, 2005, if the plan under which the deferral was made is materially modified after October 3, 2004. Reg. Section 1.409A-6(a)(1)(i).

2) A nonqualified deferred compensation plan subject to a collective bargaining agreement in effect on October 3, 2004, is not required to comply with Section 409A on or before the earlier of the date on which the collective bargaining agreement terminates (without regard to any extension thereof after October 3, 2004) or December 31, 2009. Reg. Section 1.409A-6(a)(1)(ii).

b. Grandfathered Deferrals. Section 409A does not apply to amounts deferred before January 1, 2005 (or to earnings on such deferrals after 2004), if (i) the service provider before January 1, 2005, had a legally binding right to be paid the amount, and the right to the amount was earned and vested. Reg. Section 1-409A-6(a)(2).

c. Material Modification Exception to Grandfathering.

1) If amounts are deferred before January 1, 2005, and there is a material modification after October 3, 2004, of the plan under which the deferral is made, deferrals shall be treated as amounts deferred in taxable years beginning on or after January 1, 2005. American Jobs Creation Act of 2004, Section 885(d)(2)(B).

2) A modification of a plan is a material modification if a benefit or right existing as of October 3, 2004, is materially enhanced or a new material benefit or right is added, and such material enhancement or addition affects amounts earned and vested before January 1, 2005. Such material benefit enhancement or addition is a material modification whether it occurs pursuant to an amendment or to the service recipient's exercise of discretion under the terms of the plan. Reg. Section 1.409A-6(a)(4)(i).

10. Transition Rules Through December 31, 2007.

a. Three-Year Transition or Grace Period. For a plan adopted before December 31, 2007, the plan must (a) be operated in good faith compliance with the provisions of Section 409A and previously-issued Notices from January 1, 2005 through December 31, 2007, and (b) be amended on or before December 31, 2007, to conform to the provisions of

Section 409A for non-grandfathered deferred compensation, or to provide an arrangement that does not provide deferred compensation under Section 409A. Compliance with the final regulations and the proposed regulations is not required before January 1, 2008, but any such compliance will be considered good faith compliance with the statute. Notice 2005-1, Q/A-19. Notice 2006-79, Section 3.01. Preamble to the Proposed Section 409A Regulations XI B.

b. Amendments to Provide New Payment Elections. If a plan is amended on or before December 31, 2007, to provide for new payment elections with respect to both time and form of amounts deferred prior to the election and if the service provider makes a new election on or before December 31, 2007, such election will not be treated as a change in form and timing of payment of initial deferral and redeferral elections under Section 409A(a)(4) or an acceleration of payment under Section 409A(a)(3). An amendment made in 2007 may not change election for amounts otherwise payable in 2007 nor cause payment to be made in 2007. Notice 2005-1, Q/A-19(c). Notice 2006-79, Section 3.02. Preamble to the Proposed Section 409A Regulations XI C.

c. Substitutions of Non-Discounted Stock Options and SARs for Discounted Stock Options and SARs. It is not a material modification to replace a stock option or SAR otherwise providing for deferred compensation (*e.g.*, discounted) with a stock option or SAR that would not have constituted deferred compensation (*e.g.*, not discounted) if it had been granted upon the original date of the replaced stock option or SAR. The replacement, cancellation or reissue must occur on or before December 31, 2007. However, if the discounted option is exercised before the cancellation and replacement with a non-discounted option, Section 409A will be violated. Notice 2005-1, Q/A-18(d). Notice 2006-79, Section 3.04. Preamble to the Proposed Section 409A Regulations XI H.

d. Payment Elections of Nonqualified Deferred Compensation Linked to Qualified Plans. With regard to excess benefit, 401(k) wraparound plans, other plans tied to qualified plans, including Section 403(b) annuities, Section 457(b) eligible plans and certain foreign broad based plans, an election under such nonqualified plan through December 31, 2007, which is controlled by the payment election under the qualified plan will not violate Section 409A if the timing and form of payment is made in accordance with the terms of the qualified deferred compensation plan as of October 3, 2004, that governs payments. However, payments under such nonqualified plans after 2007 must conform with the new 409A rules. Notice 2005-1, Q/A-23. Notice 2006-79, Section 3.03. Preamble to the Proposed Section 409A Regulations XII D.

III. DEFINITIONS OF DEFERRED COMPENSATION AND PLAN ARE VERY BROAD

A. WHAT IS A NONQUALIFIED DEFERRED COMPENSATION PLAN UNDER SECTION 409A?

1. Statutory Definition.

Section 409A(d)(1) gives a roundabout definition: ". . . any plan that provides for the deferral of compensation . . ."

2. Final Regulation Definition.

a. General Definition. The term "plan" is extremely broad. The final regulation states that it includes any agreement, method, program, or other arrangement, whether it applies to one person or an individual, whether it is adopted unilaterally by the service recipient or negotiated or agreed to by the service recipient and one or more service providers, and regardless of whether it is an employee benefit plan under ERISA Section 3(3). Reg. Section 1.409A-1(c)(1).

b. Establishment of a Plan.

1) Must be in Writing. A plan is established on the latest of the date on which it is adopted, the date on which it is effective, and the date on which the material terms of the plan are set forth in writing, whether in one or more documents. The material terms include the amount (or method for determining amount) of deferred compensation and the time and form of payment.

2) Earlier Establishment for Non-elective Deferrals. A plan will be deemed to be established on the date that a participant has a legally binding right to a non-elective deferral of compensation as long as the written plan requirements above are accomplished before the end of the taxable year in which the legally binding right arises (or within the first two and a half months of the subsequent year if the amount is not payable in the current or subsequent year).

3) Initial Deferral and Redeferral Election Provisions. The plan must specify in writing on or before the date the initial deferral or redeferral election becomes irrevocable the conditions under which such election may be made.

4) Payment Acceleration Provisions. The 14 payment accelerations authorized by the final regulation do not have to be included in the written plan document in order to use the acceleration exceptions. Reg. Section 1.409A-1(c)(3)(iv).

5) Six Month Delay for Specified Employees. If a plan has specified employees of a publicly traded company, the six month delay rule in payment after separation of service must be written into the plan document before the date the service provider first becomes a specified employee. Reg. Section 1.409A-1(c)(3)(v). The regulation provides that if a plan fails to contain a written six month rule, a Section 409A violation only applies to the specified employees and not to employees who are not specified.

c. Savings Clauses Ineffective. The plan must contain the above required provisions in writing and any savings clauses that purport to nullify non-compliant plan terms or purport to supply specific plan terms in accordance with Section 409A are disregarded. Reg. Section 1.409A-1(c)(1).

d. Plan Aggregation Rules. The final regulation for various purposes of the statute aggregates plans of similar types. The regulation creates nine aggregation categories which will be discussed later. Note that the aggregation rules do not apply to the written plan requirement discussed above. Reg. Section 1.409A-1(c)(3)(viii). In other words, if

one plan in an aggregation group fails the written requirements, such failure does not automatically taint the other plans in the aggregation group.

e. Miscellaneous Rules. A determination of whether a plan provides deferred compensation is made at the time the service provider obtains a legally binding right to the compensation under the plan. A retroactive change of the plan to remove the deferred compensation element is ignored. If the principal purpose of the plan is to achieve a result with respect to a deferral of compensation that is inconsistent with the purposes of Section 409A, the Commissioner may treat the plan as covered by the statute and the regulations. Reg. Section 1.409A-1(a)(1).

f. Comment. With regard to the definition of a plan, the final regulations are more taxpayer friendly than the proposed regulations. Less items are required to be included in the written plan and the aggregation groups have been greatly expanded in number.

3. Plans Excluded From 409A By Statute.

a. Qualified Employer Plans.

1) Statutory Definition. Section 409A(d)(2). The term "qualified employer plan" means any plan, contract, pension, account, or trust described in subparagraph (A) or (B) of Section 219(g)(5) (without regard to subparagraph (A)(iii), a Section 457(b) eligible deferred compensation plan and a qualified governmental excess benefit arrangement under Section 415(m).

The statute also excludes from Section 409A non-elective deferred compensation plans excluded from Section 457(e)(12) but only if such compensation is provided under a nonqualified deferred compensation plan which was in existence on May 1, 2004, which was providing non-elective deferred compensation as of such date and which was established or maintained on July 2, 1974. If such a plan adopts an amendment that provides for a material change in classes of individuals eligible to participate after May 1, 2004, the new nonqualified deferred compensation rules will apply to any non-elective deferred compensation under the plan on or after the date of adoption of the amendment. Section 409A(d)(3).

2) Final Regulation Clarifications. Reg. 1.409A-1(a)(2) confirms that the qualified employer plan exception includes the qualified retirement plan described in Section 401(a) and a trust exempt from tax under Section 501(a) or that is described in Section 402(d); an annuity plan described in Section 403(a); an annuity contract described in Section 403(b); any simplified employee pension within the meaning of Section 408(k); any simple retirement account within the meaning of Section 408(p); any plan under which an active participant makes deductible contributions to a trust described in Section 501(c)(18) and certain Puerto Rican plans described in Section 1022(i)(2) of ERISA.

3) Ineligible Plans Under Section 457 Covered. Reg. Section 1.409A-1(a)(4) clarifies that, although eligible plans under Section 457(b) are not subject to the requirements of Section 409A, ineligible plans under Section 457(f) may be covered. The length

of service awards to bona fide volunteers under Section 457(e)(11)(A)(ii) are not subject to Section 409A.

(a) Non-elective deferred compensation of non-employees described in Section 457(e)(12) and a grandfathered plan or arrangement described in Section 1.457-2(k)(4) also may be subject to Section 409A.

(b) The regulations state that a payment under a Section 457(f) plan generally means the provision of cash or property to the service provider. However, for application of the short term deferral rule, inclusion in income of an amount under Section 457(f) is treated as a payment of the amount. The preamble to the final regulation explains that where the income inclusion under Section 457(f) stems from a lapse of a risk of forfeiture as defined under Section 409A, the amount included in income will be considered a short term deferral for purposes of Section 409A and therefore excluded from the definition of deferred compensation. However, the preamble goes on to say that the right to earnings on amounts that have previously been included under Section 457(f) will be deferred compensation for purposes of Section 409A unless the right to the earnings independently satisfies the requirements for an exclusion. Final Section 409A Regulations Preamble II B.

b. Certain Welfare Benefit Plans.

1) Statutory Exclusion. Section 409A(d)(1)(B). The statute excludes any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.

2) Final Regulation Provisions. Reg. Section 1.409A-1(a)(5).

(a) The regulation confirms that the term nonqualified deferred compensation plan does not include any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan.

(b) The FICA withholding definitions for death benefits and disability pay apply for Section 409A. Reg. Section 31.3121(v)(2)-1(b)(4)(iv)(C). Thus death benefits and disability pay are excluded from nonqualified deferred compensation only to the extent that the total death benefit or disability benefit payable under the plan exceeds the lifetime benefits payable under the plan.

(c) The regulation states that the welfare benefit exclusion also applies to any Archer medical savings account as described in Section 220, any health savings account as described in Section 223, or any other medical reimbursement arrangement, including a health reimbursement arrangement, that satisfies the requirements of Section 105 and Section 106 (excludable from income). The regulation clarifies that any such benefits or reimbursements which are includable in income could be subject to Section 409A.

(d) Notice 2005-1, Q/A 6 provides that, until further guidance, participants in a Section 457(f) plan may rely on the definitions of bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan applicable for Section 457(f) purposes as also being applicable for Section 409A purposes. The preamble to the

regulation states that taxpayers may continue to rely on such definitions for purposes of Section 409A until further guidance. Preamble to the Final Section 409A Regulations II A.

4. Plans Excluded From 409A by Regulation.

a. Certain Arrangements with Independent Contractors. Reg. Section 1.409A-1(f)(2).

1) Although the term "service provider" can include an independent contractor, a plan between an independent contractor and a service recipient is excluded from Section 409A if (i) the independent contractor is actively engaged in the trade or business of providing services, other than as an employee or a director (or a similar position to director); (ii) the independent contractor provides significant services to two or more service recipients to which the service provider is not related and are not related to one another; and (iii) the independent contractor is not related to the service recipient.

2) For this purpose, a person is related to another person if the persons bear a relationship to each other that is specified in Section 267(b) or 707(b)(1) (changing 50% to 20%) and Section 267(c)(4) is applied as if the family of an individual includes the spouse or any member of the family. Related persons also include persons engaged in trades or businesses under common control (within the meaning of Section 52(a) and (b)). Finally, an individual is related to an entity if the individual is an officer of an entity that is a corporation, or holds a position substantially similar to an officer of a corporation with an entity that is not a corporation.

3) Whether an independent contractor provides "significant services" depends on the facts and circumstances of each case. However, as a safe harbor, there are significant services if an independent contractor provides services to two or more service recipients to which the independent contractor is not related and which service recipients are not related to each other if the amounts of revenue from any one of the service recipients does not exceed 70% of the total revenues provided by the service provider from the trade or business providing such services.

4) The final regulation adopts an additional safe harbor for significant services. A contractor who has actually met the 70% threshold test in the three immediately previous years is deemed to meet the 70% threshold for the current year, but only if at the time the amount is deferred, the independent contractor does not know or have reason to anticipate that the independent contractor will fail to meet the threshold in the current year.

5) The final regulation also excludes plans between an independent contractor and a related service recipient if the plan is a bona fide agreement arising in the ordinary course of a particular trade or business in which the independent contractor is engaged to the extent that the services are bona fide, arise in the ordinary course of business, and are substantially the same as arrangements and practices applicable to one or more unrelated service recipients to whom the independent contractor provides substantial services and that produce a majority of the total revenue that the independent contractor earns from the trade or business providing such services during the taxable year.

6) Regardless of the above, an independent contractor is always treated as related to the service recipient and therefore is subject to Section 409A if the service provider provides management services to the service recipient. "Management services" involve the actual or de facto direction or control of the financial or operational assets of a trade or business or investment in advisor services provided to a service recipient whose primary trade or business includes management of financial assets such as a hedge fund or a real estate investment trust.

7) The preamble states that the IRS is studying the issue of whether a service recipient is permitted to rely upon a representation of an independent contractor that it meets the exclusion requirements of the regulation. Preamble to the Final Section 409A Regulations II C.

b. Certain Foreign Nonqualified Deferred Compensation Plans. Reg. Section 1.409A-1(a)(3).

1) Treaty Obligations. Contributions under a deferred compensation plan are not subject to Federal income tax for a foreign national if excluded pursuant to any bilateral income tax convention to which the United States is a party.

2) Participation by Nonresident Aliens, Certain Resident Aliens and Bona Fide Residents of Possessions. Excluded is deferred compensation from any broad-based foreign retirement plan with respect to an alien individual for a taxable year during which such individual is a nonresident alien, a resident alien (classified as such solely under Section 7701(b)(1)(A)(ii)) or a bona fide resident of a United States possession. Deleted is a restriction in the proposed regulation that the plan sponsor had to be a non-United States person. Now the plan can be sponsored by any person.

3) Participation by U.S. Citizens and Lawful Permanent Residents. For a U.S. citizen, a resident alien (classified as such under Section 7701(b)(1)(A)(i)), and a bona fide resident of a U.S. possession who are not eligible to participate in a qualified employer plan, excluded are contributions to a broad-based foreign retirement plan but only with respect to non-elective deferrals of modified foreign earned income and only to the extent that such amounts deferred under such plan in such taxable year do not exceed the applicable limits of Section 415(b) and (c) that would be applicable if the plan were subject to Section 415 and the modified foreign earned income of such individual were treated as compensation for purposes of applying Section 415(b) and (c).

(a) An individual is eligible to participate in a qualified employer plan if under the terms of the plan and without further amendment or action by the plan sponsor, the individual is eligible to make or receive contributions or accrue benefits under the plan (regardless of whether the individual has elected to participate in the plan).

(b) Deleted is the proposed regulation requirement that the service recipient not be a U.S. person. Now the exclusion applies to any service recipient whether or not a U.S. person.

(c) The exception also covers certain participation by a U.S. citizen or lawful permanent resident who works overseas during only part of the year, and therefore is not a bona fide resident of a foreign country for an uninterrupted period that includes an entire taxable year, or is not present in a foreign country at least 330 full days during a period of 12 consecutive months.

(d) The exclusion for U.S. citizens and lawful permanent residents applies to non-elective deferrals even if elective deferrals are permitted under the same plan, provided that the amounts deferred through non-elective deferrals and earnings on such amounts are distinguishable from amounts deferred through elective deferrals and earnings on such amount, such as through the use of separate accounts. Preamble to the Final Section 409A Regulations III A 2.

4) Plans Subject to a Totalization Agreement and Similar Plans. Excluded are benefits that are provided under or contributions made to a government-mandated plan as part of a foreign jurisdiction's social security system.

5) Definition of Broad-Based Foreign Retirement Plan. This is a plan that satisfies the following conditions: (i) nondiscriminatory insofar as employees constitute a wide range, substantially all of whom are nonresident aliens, resident aliens classified as resident aliens classified as such solely under Section 7701(b)(1)(A)(ii)) or bona fide residents of a U.S. possession, including rank and file employees; (ii) alone or in combination with other comparable plans actually provide significant benefits for a substantial majority of such covered employees; (iii) the benefits actually provided under the plan to such covered employees are nondiscriminatory; and (iv) the plan contains provisions or is subject to tax law provisions or other legal restrictions that generally discourage employees from using plan benefits for purposes other than retirement or restrict access to plan benefits before separation from service including restricting in service distributions except in events similar to an unforeseeable emergency.

B. WHAT CONSTITUTES DEFERRED COMPENSATION UNDER SECTION 409A?

1. Statutory Definition.

Section 409A(g) is broad and not very helpful: ". . . any deferrals for the year under a deferred compensation plan. . . , whether or not paid."

2. Final Regulation Definition.

a. General Definition. ". . . 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, pursuant to the terms of the plan, is or may be payable to (or on behalf of) the service provider in a later taxable year." Reg. Section 1.409A-1(b)(1).

b. Legally Binding Right -- Not Property Subject to Unilateral Reduction or Elimination. Reg. Section 1.409A-1(b)(1).

1) A service provider does not have a legally binding right to compensation to the extent that compensation may be reduced unilaterally or eliminated by the service recipient or other person after the services creating the right to the compensation had been performed. In other words, there is no legally binding right to compensation which can be reduced.

2) However, if the facts and circumstances indicate that the discretion to reduce or eliminate the compensation is available or exercisable only upon a condition, or the discretion to reduce or eliminate the compensation lacks substantial significance, the service provider will be considered to have a legally binding right to the compensation. This depends upon the facts and circumstances.

3) There is no substantive significance to the power to reduce or eliminate if the service provider has effective control over the person retaining such discretion, or has effective control over any portion of the compensation of the person retaining the discretion, or is a member of the family (as defined in Section 267(c)(4) applied as if the family of an individual includes the spouse of any member of the family) of the person retaining such discretion.

4) There is no unilateral reduction or elimination power if the reduction or elimination is by operation of the objective terms of the plan. This could be a substantial risk of forfeiture instead.

5) The service provider has a legally binding right even though the compensation formula provides for benefits to be offset by benefits provided under a qualified plan or benefits are reduced due to actual or notional investment losses, or subsequent decreases in compensation in a final average pay plan.

c. Payable in Later Taxable Year. The test of deferred compensation is whether it "may be payable" in a later taxable year even though it is paid in the year in which the legally binding right first occurs. The preamble to the final regulation gives an example of deferred compensation where there was an irrevocable election to defer salary to a future year although it was actually paid in the year in which services were performed resulting in impermissible acceleration of payment. The preamble also gives an example where a plan grants the right to separation pay although the separation and payment was done in the same year as the grant since the payment was conditional upon an event that may have occurred in a future year. Preamble to the Final Section 409A Regulations III A.

d. Earnings on Deferred Compensation. Reg. Section 1.409A-1(b)(2).

1) Deferred compensation includes earnings on the deferred compensation.

2) The legally binding right to earnings arises at the time of the deferral of the compensation to which the earnings relate when the right to earnings is specified under the terms of the plan.

3) A plan may provide that the time and form of payment of earnings is treated separately from the time and form of payment of the underlying compensation and therefore is a separate plan..

3. Items Excluded From Deferred Compensation By Regulation.

a. Non-Taxable Benefits. Reg. Section 1.409A-1(b)(1). Deferred compensation does not include an amount which would otherwise be excluded from income unless the service provider has received the right to excludable income in exchange for, or as the right to exchange the right for, an amount that will be includable income (other than due to participation in a cafeteria plan described in Section 125).

b. Payroll Period Exception. Reg. Section 1.409A-1(b)(3).

1) The statute does not apply to compensation paid after the last day of the service provider's taxable year if paid in accordance with the service recipient's normal payroll period for compensation as described in Section 3401(b).

2) If the service provider is an independent contractor, where there is no payroll period, a period not longer than the payroll period specified in Section 3401(b) or, if no payroll period exists, the earlier of the timing the service recipient normally pays independent contractor service providers or thirty days after the end of the service provider's taxable year.

c. Short Term Deferrals. Reg. Section 1.409A-1(b)(4).

1) General Rule. There is no deferred compensation if the plan does not provide for a deferred payment date and the service provider actually or constructively receives such payment on or before two and a half months from the end of the later of the service provider's first taxable year or the service recipient's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture. This is a surprisingly liberal rule. An amount of compensation could be deferred for several years but will not be subject to the statute if it is paid within two and a half months after the end of the appropriate taxable year in which the compensation is vested.

2) Actual or Constructive Payment. The regulation provides that payment is actually or constructively received if the payment is includable in income such as under Section 83, the economic benefit doctrine, Section 402(b) or Section 457(f).

3) When Vested if No Substantial Risk of Forfeiture. The appropriate tax years are determined as of the first date the service provider has a legally binding right to payment if there is no substantial risk of forfeiture.

4) What is a Deferred Payment? If the plan provides for a payment that will be made or completed after any date, or upon the occurrence of any event, that will or may occur later than the end of the applicable two and a half month period (such as separation from service, death, disability, change in control event, specified time or schedule of payment, or unforeseeable emergency) regardless of whether that amount is actually paid within

the applicable two and a half month period. Thus, the short term deferral rule does not apply if the payment may be made later than the applicable two and a half month period even though it is actually paid within such period.

If the plan does not provide for a payment event or date but the service provider has the ability to elect such payment event or date, the right of election is ignored for short term deferral purposes unless the service provider in fact elects a payment date or event which could be beyond the applicable two and a half month period.

5) How Does Rule Apply to a Series of Payments? Normally, if a series of payments overlaps the two and a half month applicable period and are treated as a single payment under Reg. Section 1.409A-2(b)(2), none of the payments will qualify for the short term deferral rule. For example, a life annuity is always treated as a single payment and a series of installment payments are normally treated as a single payment. However, if the plan treats each installment payment as a separate payment, those made within the two and a half month applicable period will qualify for the short term deferral and those made after that period will not.

6) Exceptions to the Two and a Half Month Rule. There are three exceptions to paying the short term deferral within two and a half months from the end of the appropriate taxable year:

(a) First, it was administratively impracticable to make the payment on time and, as of the date upon which the legally binding right to the compensation arose, such impracticability was unforeseeable.

(b) Second, payment by the end of the applicable two and a half month period would jeopardize the ability of the service recipient to continue as a going concern (this exception was liberalized from the proposed regulation which tied it to insolvency and unforeseeability).

(c) Third, the service recipient reasonably anticipates that its deduction with respect to such payment would not be permitted by Section 162(m) and, as of the date the legally binding right to the payment arose, a reasonable person would not have anticipated the application of Section 162(m) at the time of the payment.

(d) For all exceptions, the payment must be made as soon as administratively practicable, or as soon as the payment would no longer jeopardize the ability of the service recipient to continue as a going concern or after the deduction is no longer restricted by Section 162(m), as the case may be.

7) Perhaps the Short Term Deferral Should Be Written into the Plan. The preamble to the proposed regulation for Section 409A stated that the short term deferral relevant deadline does not have to be written into the deferred compensation arrangement. The short term exception applies if the amount is actually paid by the appropriate deadline and there is no specified payment date. Preamble to the Proposed Section 409A Regulations II B. The preamble points out that the failure to pay timely would trigger Section 409A since there is no distribution date specified unless one of the three narrow exceptions

discussed above apply. On the other hand, if the distribution date is specified, even though Section 409A applies, the more liberal exceptions for delayed payments under Reg. Section 1.409A-3(b) could apply, most liberal of which is that the payment may be made by the later of the end of the calendar year or the 15th day of the third calendar month after the specified payment date. Thus, it will often be appropriate to include the deadline for short term deferral in the written arrangement.

8) No Exception for an Unintentional Error. The preamble to the proposed regulation stated that no exception is made for failure to meet the short term deferral deadline because of unintentional error. Preamble to the Proposed Section 409A Regulations II B. The final regulation did not make an exception for unintentional error either.

d. Statutory Stock Options. Reg. Section 1.409A-1(b)(5)(ii).

1) The statute does not apply to incentive stock options under Section 422 or employee stock purchase plans under Section 423 even though a discounted purchase price is involved.

2) However, if a statutory stock option is modified, extended or renewed so that it is ineligible to be treated as a statutory stock option, such modification or other event is treated as a grant of a new option or causes the option to be treated as having had a deferral feature from the date of the grant and is subject to Section 409A only if such modification or other event would have been so treated had the option been a non-statutory stock option immediately before such modification or other event. For example, where an incentive stock option is modified through an extension of the option's term, the extended option will be treated as having had an additional deferral feature from the date of grant for Section 409A purposes only if the same extension of a non-statutory stock option would have resulted in such treatment. Preamble to the Final Section 409A Regulations III D 2.

e. Certain Non-Statutory Stock Options and SARs.

1) Stock Option Exception. A non-statutory stock option for service recipient stock does not constitute deferred compensation if: Reg. Section 1.409A-1(b)(5)(i)(A).

(a) The exercise price may never be less than the fair market value of the underlying stock on the date the option is granted and the number of shares subject to the option is fixed on the original date of the grant of the option;

(b) The transfer or exercise of the option is subject to taxation under Section 83; and

(c) The option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of the exercise or disposition of the option or the time the stock acquired pursuant to the exercise of the option become substantially vested (as defined in Reg. Section 1.83-3(b)).

2) SAR Exception. The SAR with regard to service recipient stock is not deferred compensation if: Reg. Section 1.409A-1(b)(5)(i)(B).

(a) The compensation payable under the SAR cannot be greater than the excess of the fair market value of the stock on the date the SAR is exercised over the amount specified as the exercise price on the date of grant of the SAR with respect to a number of shares fixed on or before the date of grant of the right;

(b) The SAR exercise price may never be less than the fair market value of the underlying stock on the date the right is granted; and

(c) The SAR right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the SAR.

3) Bottom Line. A stock option or a SAR is not excluded from the deferred compensation subject to 409A if it involves stock other than a recipient stock, a discounted SAR or option, or contains a feature of deferral of compensation.

4) Additional Feature for Deferral of Compensation. To the extent the stock right provides a right other than to receive cash or stock on the date of the exercise and such additional right would otherwise allow compensation to be deferred beyond the date of exercise, the entire stock right will fall within Section 409A. The regulation clarifies that the receipt of substantially non-vested stock upon exercise of the stock right or the right to pay the exercise price with previously acquired shares is not a deferral feature. Reg. Section 1.409A-1(b)(5)(i)(D). An example of a deferral feature is an ability to swap the stock option for a split dollar contract or a deferred compensation arrangement which would defer the taxation of the gain.

5) Rights to Dividends. If the service provider is entitled to all or part of the dividends to service recipient stock underlying the stock option or SAR from the date of grant until the date of exercise of the option or SAR contingent upon exercising the stock right, such dividends will be considered as an offset to the exercise price or an increase in the amount payable under the SAR which would be a discount subject to Section 409A. If the right to dividends declared is not contingent upon the exercise of the stock right, it may be deferred compensation subject to Section 409A (unless it independently qualifies for an exception from coverage) but it will not affect the related stock right from exclusion under Section 409A. Reg. Section 1.409A-1(b)(5)(i)(E).

6) Stock of Service Recipient. Only stock of the service recipient is eligible for the exception under the non-statutory stock option and SAR rules.

(a) Service recipient stock means a class of stock that, as of the date of grant, is common stock for purposes of Section 305 of a corporation that is an eligible issuer of such stock. Reg. Section 1.409A-1(b)(5)(iii)(A).

(b) The stock will not qualify as service recipient stock if it has any preferences as to distributions other than in liquidation of the issuer. Neither does

the term include stock that is subject to a mandatory repurchase obligation other than a right of first refusal, or a put or call right that is not a lapse restriction as defined in Reg. 1.83-(iii) if the stock price is based on a measure other than fair market value. Reg. Section 1.409A-1(b)(5)(iii)(A).

(c) American depository receipts issued with regard to stock traded on a foreign securities market can be treated as service recipient stock to the extent that the stock traded on the foreign securities market would qualify as service recipient stock. Reg. Section 1.409A-1(b)(5)(iii)(B).

(d) Mutual company units may also constitute service recipient stock if the unit represents a fixed percentage of the overall value of a non-stock mutual company. Reg. Section 1.409A-1(b)(5)(iii)(C).

(e) An interest in any other entity may constitute service recipient stock to the extent designated by the Commissioner. Reg. Section 1.409A-1(b)(5)(iii)(C).

7) Definition of Eligible Issuer of Service Recipient Stock. Reg. Section 1.409A-1(b)(5)(iii)(E).

(a) General Rule. An eligible issuer is a corporation for which the service provider provides direct services and includes the stock of any corporation and any chain of organizations, all of which have a controlling interest in another organization beginning with the parent organization and ending with the organization for which the service provider was providing services at the date of the stock right. Reg. Section 1.409A-1(b)(5)(iii)(E)(1). In other words, an eligible issuer of service recipient stock is the immediate employer plus any entities in a control chain above that employer but not any entities down the chain. Thus, the employer cannot issue stock options or SARs for stock of a subsidiary or for stock of a brother/sister corporation.

(1) In determining a controlling interest, the rules of Reg. Section 1.414(c)-2(b)(2)(i) are used except that 50% is substituted for 80% control.

(2) Based upon legitimate business criteria, the control rules of Reg. Section 1.414(c)-2(b)(2)(i) can be used for this purpose substituting 20% control for 80% control. The determination of whether a grant is for a legitimate business criteria is based on the facts and circumstances, focusing primarily on whether there is a sufficient nexis between the service provider and the issuer of the stock right so that the grant serves a legitimate non-tax business purpose other than simply providing compensation to the service provider that is excluded from the requirements of Section 409A.

(i) An example of legitimate business criteria involves service providers of a joint venture who were former service providers of the service recipient owning at least 20% in the joint venture.

(ii) Another example of a legitimate business criteria is where the corporate venturer would issue the stock right to an employee of

the joint venture who is reasonably expected to become a future employee of the corporate venturer.

(iii) However, there is no real nexis of the service provider with a corporate venturer where the corporate venturer is a passive investor in the service recipient joint venture. Likewise, generally there is no legitimate business criteria if the corporation only owns a minority interest in the entity that holds a minority interest in the joint venture.

(b) Investment Vehicles Excluded. An eligible issuer of service recipient stock does not include any corporation whose primary purpose is to serve as an investment vehicle with respect to the corporation's minority ownership interest in entities other than the service recipient. However, the direct service provider of the investment vehicle may receive his or her employer's stock. Reg. Section 1.409A-1(b)(5)(iii)(E)(2).

(c) Anti-Abuse Rules. The term eligible issuer of service recipient stock does not include a corporation if the purpose of establishing the corporation or a purpose of a significant transaction between that corporation and another service recipient entity is to provide deferred compensation not subject to Section 409A. It is presumed that such structure was so established if the primary source of income or value for such corporation arises from the provision of management services to other members of the service recipient group. Reg. Section 1.409A-1(b)(5)(iii)(E)(3).

8) Valuation of Recipient Stock Subject to Option or SAR. Reg. Section 1.409A-1(b)(5)(iv). This portion of the final regulation discusses the method of valuing the fair market value of the recipient's stock in setting the exercise price of the stock option at the date of the grant and the measuring value at the date of grant for determining appreciation of a SAR.

(a) Stock Readily Tradable on an Established Securities Market. If the service recipient stock is readily tradable on a securities market, the fair market value of the stock may be determined based upon the last sale before or the first sale after the grant, the closing price on the trading day before or the trading day of the grant, the arithmetic mean of the high and low prices on the trading day before or the trading day of the grant, or any other reasonable method using actual transactions in such stock as reported by such market. Reg. Section 1.409A-1(b)(5)(iv)(A).

(1) Fair market value may also be determined by using an average selling price during a specified period that is within 30 days before or 30 days after the valuation date; provided that the program under which the stock right is granted must irrevocably specify the commitment to grant the stock right before the beginning of the 30 day period.

(2) The average selling price refers to the arithmetic mean of such selling prices on all trading days during the specified period, or the average of such prices over the specified period weighted based on the volume of trading of such stock on each trading day during such period.

(3) The service recipient must designate the recipient of the stock right, the number and class of shares of stock that are subject to the stock right, and the method for determining the exercise price including the period over which the averaging will occur before the beginning of the specified averaging period.

(4) However, if applicable foreign law requires that a compensatory stock right be priced based upon a specific price averaging method and period, the stock right granted in accordance with applicable foreign law will be treated as meeting the fair market value requirements provided that the averaging period does not exceed 30 days.

(b) Stock Not Readily Tradable on an Established Securities Market. Reg. Section 1.409A-1(b)(5)(iv)(B).

(1) General Rule. In determining the fair market value of stock not readily tradable on a securities market, the value can be determined by the reasonable application of any reasonable valuation method. This is based upon the facts and circumstances.

(2) Factors Considered for Reasonable Valuation. Factors to be considered under the reasonable valuation method include the value of tangible and intangible assets of the corporation, the present value of anticipated future cash flows of the corporation, the market value of stock or equity interests in similar corporations and other entities engaged in trades or businesses substantially similar to those engaged in by the corporation (if the value of such corporations or entities can be readily determined through non-discretionary, objective means such as trading prices on established securities markets, or an amount paid in an arm's length private transaction), recent arm's length transaction involving the sale or transfer of such stock or equity interest, and other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation method is used for other purposes that have a material economic effect on the service recipient, its stockholders or its creditors. The service recipient's consistent use of a valuation method to determine the value of its stock or assets for other purposes, including purposes unrelated to the compensation of service providers.

(3) Not Reasonable Valuation Methods. A valuation method is not reasonable if it does not take into consideration all available information material to the value of the corporation, the valuation used does not reflect subsequent information that may materially affect the value of the corporation (*e.g.*, the resolution of material litigation or the issuance of a patent), or the prior valuation was more than 12 months earlier than the date of the current valuation.

(4) Presumption of Reasonableness. Reg. Section 1.409A-1(b)(5)(B)(2). Although the IRS may rebut such presumption by showing that it is grossly unreasonable, the following create a presumption of reasonable valuation:

(i) A valuation determined by an independent appraisal meeting the requirements of Section 401(a)(28)(C) as of a date no more than 12 months before the relevant valuation date.

(ii) A valuation based upon a generally applicable repurchase formula (applicable for both compensatory and non-compensatory purposes) in the case of an illiquid stock of a start-up corporation, a valuation made reasonably in good faith and evidenced by a written report that takes into account the relevant factors described above provided that the service recipient or service provider does not anticipate a change of control within 90 days of the valuation date or a public offering of securities within 80 days following such valuation date. Such valuation must be performed by a person or persons the corporation reasonably determines is qualified to perform such valuation based upon experience, education, or training with at least five years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry in which the service recipient operates.

(iii) A formula that, if used as part of a nonlapse restriction with respect to stock, would be considered fair market value of stock pursuant to Reg. Section 1.83-5, provided that such stock is valued in the same manner to the transfer of shares of such class of stock to the issuer or a person owning 10% or more of the stock of the issuer, but is not required to be applicable to transactions with other persons or transactions that are part of an arm's length transaction constituting the sale of all or substantially all the stock of the issuer to an unrelated purchaser and such valuation is used consistently for all purposes.

(5) Use of Alternative Valuation Methods. Reg. Section 1.409A-1(b)(5)(iv)(B)(3). A different valuation method may be used for each separate action for which a valuation is relevant, provided that a single valuation method is used for each separate action and, once used, may not retroactively be altered (*e.g.*, one valuation method to determine the exercise price of a stock option and a different valuation method to determine the value at the date of repurchase of the stock pursuant to a put or call right). If the service recipient stock that has been valued in accordance with one of the above methods subsequently becomes publicly traded, then the service recipient must use the valuation method for publicly traded stock in determining the payment at the date of exercise or purchase of the stock and discontinue the use of one of the above valuation methods.

(c) Transitional Valuation Rules. In Notice 2006-4, 2006-3 I.R.B. 1, January 17, 2006, the IRS gave interim guidance for valuing stock options and SARs until the regulations were finalized.

(1) For stock options and SARs issued before January 1, 2005, which are not grandfathered from Section 409A, the valuation rules for incentive stock options under Reg. Section 1.422-2(e)(2) may be used – good faith attempt to meet fair market value as shown by relevant facts and circumstances.

(2) For stock options and SARs issued on or after January 1, 2005, but before the regulations become final, taxpayers can determine fair market value under Notice 2005-1, Q/A-4(d)(ii) or proposed Reg. Section 1.409A-1(b)(5)(i)(B).

(3) The preamble to the final regulation supersedes Notice 2006-4 with respect to stock rights issued in taxable years of the service provider beginning on or after January 1, 2008, but reaffirms that the transition rule continues to apply before that date. Preamble to the Final Section 409A Regulations XII. However, the preamble states that taxpayers may rely upon the final regulations for taxable years beginning before January 1, 2008, if they find it preferable.

9) <u>Modifications, Extensions, Substitutions and Assumptions of Stock Rights</u>. Reg. Section 1.409A-1(b)(5)(v).

(a) <u>Modifications</u>. Reg. Section 1.409A-1(b)(5)(v)(A).

(b) <u>General Rule</u>. Modification of the terms of a stock right is considered to be a grant of a new stock right requiring the stock right to meet the requirements of Section 409A at such time.

(1) <u>Definition</u>. A modification is any change in the terms of the stock right (or change in the terms of a plan pursuant to which a stock right is granted) that may provide the holder of the stock right with a direct or indirect reduction in exercise price of the stock right regardless of whether the holder in fact benefits from the change in terms. Reg. Section 1.409A-1(b)(5)(v)(B).

(2) <u>Not Modification</u>. It is not a modification to shorten the time for exercising the stock right, to add a feature providing the ability to tender previously acquired stock for stock purchase under the stock right, to hold or have withheld shares of stock to facilitate the payment of the exercise price or employment taxes or require withholding taxes resulting from the exercise of the stock right, or for the grantor to exercise discretion specifically reserved under a stock right with respect to the transferability of the stock right.

(c) <u>Extensions</u>. Reg. Section 1.409A-1(b)(5)(v)(C).

(1) <u>General Rule</u>. An extension of a stock right is treated as an additional deferral feature retroactive to original date of the stock right making the original grant subject to Section 409A.

(2) <u>Definition</u>. An extension of a stock right is a grant of a period for exercise of the stock right beyond the original time, the conversion or exchange of a stock right for a legally binding right to compensation in a future taxable year, or the addition of any feature for the deferral of compensation not permitted for the exclusion of a stock option or a SAR. Reg. Section 1.409A-1(b)(5)(v)(C)(1).

(3) <u>Permitted Extensions</u>. It is not an extension subjecting the stock right to Section 409A if, at the time of the extension, the exercise price

equals or exceeds fair market value of the service recipient stock (*e.g.*, stock right underwater), if the exercise period for the stock right is extended to a date no later than the earliest of the latest date upon which the stock right could have expired by its original terms or the 10th anniversary of the original date of grant of the stock right, or, if the expiration of the stock right is tolled while the holder cannot exercise the stock right because it would violate an applicable Federal, state, local or foreign law or would jeopardize the ability of the service recipient to continue as a going concern, provided that the period during which the stock right may be exercised is not extended more than 30 days after the violation of such law would no longer occur.

(d) Substitutions and Assumptions of Stock Rights by Reason of a Corporate Transaction. Grant of new stock rights or changes in the form of payment pursuant to a corporate transaction are permissible if the incentive stock option requirements of Reg. Section 1.424-1 are satisfied with certain modifications. Also, a replacement of stock right options pursuant to a spin-off transaction are permitted under certain situations. Reg. Section 1.409A-1(b)(5)(iii)(E)(4) and (v)(D).

f. Restricted Property. Reg. Section 1.409A-1(b)(6).

1) General Rule. There is no deferred compensation merely because property is not includable income by reason of the property being substantially non-vested (as defined in Reg. Section 1.83-3(b)), or is includable in income solely due to a valid election under Section 83(b). Reg. Section 1.409A-1(b)(6)(i).

2) Doesn't Apply to Promises to Transfer Property. A plan under which a service provider obtains a legally binding right to receive property in a future year where the property will be substantially vested (as defined in Reg. Section 1.83-3(b)) at the time of transfer of the property may provide for the deferral of compensation and, accordingly, may constitute a nonqualified deferred compensation plan. Reg. Section 1.409A-1(b)(6)(ii).

3) Promise to Transfer Non-Vested Property is Not Deferred Compensation. A legally binding right to receive property in a future year where the property will be substantially non-vested (as defined in Reg. Section 1.83-3(b)) at the time of the transfer will not constitute deferred compensation unless offered in conjunction with another legally binding right that constitutes a deferral of compensation. Reg. Section 1.409A-1(b)(6)(ii).

4) Restricted Stock Units. Since a restricted stock unit (RSU) is a promise to transfer vested stock at a future date, it could be subject to Section 409A.

(a) However, the typical RSU would be exempt from Section 409A under the two and a half month short term deferral rule since the RSU is usually exchanged for stock as soon as it vests. But the vested stock under the RSU plan must be received within the short term deferral period.

(b) Most RSU (and phantom stock plans) provide for payment of dividend equivalents to RSU owners when dividends are declared on outstanding stock. Is the dividend equivalent subject to Section 409A?

(1) If the dividend equivalent right is subject to a substantial risk of forfeiture and is vested at the date RSU is vested, the short term deferral exception should apply.

(2) If the dividend equivalent is vested at declaration of each dividend but paid when the RSU vests, short deferral exception probably would not apply to the dividend. Perhaps the dividend equivalent can be treated as a separate arrangement by a written agreement subject to Section 409A.

(3) If the dividend equivalent is paid as declared and not accumulated, the RSU can provide that the dividend must be paid no later than March 15 of the year after declaration of the dividend in order to meet the short term deferral exception.

(4) If the dividend equivalent violates Section 409A, does it taint the underlying RSU? That may well be the case. With regard to stock options and SARs, the final regulation states that the right to dividends may or may not be deferred compensation but that they will not taint the underlying option or SAR. But that statement is restricted to stock options and SARs. Reg. Section 1.409A-1(b)(5)(i)(E). The safe approach is to expressly provide in the written contract that the dividend equivalent is a separate plan from the underlying RSU for Section 409A purposes.

g. <u>Certain Foreign Compensation</u>. Reg. Section 1.409A-1(b)(8).

1) <u>Compensation Excluded by Treaty or Other International Agreement</u>. There is no deferral of compensation to the extent compensation would have been excluded from gross income for Federal income tax purposes under the provisions of any bilateral income tax convention or other bilateral or multilateral agreement to which the United States is a party if the compensation had been paid to the service provider at the time that the legally binding right to the compensation first arose, or, if later, the time that the legally binding right was no longer subject to a substantial risk of forfeiture. Reg. Section 1.409A-1(b)(8)(i).

2) <u>Compensation Not Otherwise Taxable</u>. There is no deferral of compensation to the extent that compensation from a plan to a service provider would not have been includable in gross income for Federal tax purposes if paid at the time that the legally binding right to the compensation first arose or, if later, the time that the legally binding right was no longer subject to a substantial risk of forfeiture due to the service provider being a non-resident alien and compensation excludable under Section 872, the service provider being a qualified individual and compensation would have been foreign earned income under Section 911 subject to certain modifications, or the compensation would have been excludable from gross income under Section 893, 931 or 933. Reg. Section 1.409A-1(b)(8)(ii).

3) <u>Tax Equalization Agreements</u>. Reg. Section 1.409A-1(b)(8)(iii).

(a) Tax equalization payments to a U.S. person working overseas are excluded as deferred compensation under Section 409A.

(b) A tax equalization agreement provides for payments to compensate the service provider for some or all of the difference in taxes posed by a foreign jurisdiction or a U.S. Federal, state or local jurisdiction on the same compensation.

(c) To be excluded, the payment must be made by the end of the second taxable year of the service provider following the latest of the deadline for filing the U.S. Federal tax return or the deadline for filing a foreign tax return (or if a foreign return is not required to be filed, the due date for the foreign tax payment) reflecting the compensation for which the tax equalization payment is provided. If the payment is related to audit or litigation in the U.S. or abroad, the payment must be made by the end of the year following the year in which the audit or litigation establishes the payment.

4) Certain Limited Deferrals of a Non-Resident Alien. With respect to non-resident aliens, excluded from deferred compensation is compensation under a foreign plan for a taxable year up to the applicable dollar amount under Section 402(g)(1)(B) for the taxable year ($15,500 in 2007). Reg. Section 1.409A-1(b)(8)(iv).

(a) If the payments under such foreign plan exceed the applicable dollar amount, only the excess may be deferred compensation.

(b) A foreign plan is a plan that, together with all substantially similar plans, is maintained by a service recipient for a substantial number of participants, substantially all of whom are non-resident aliens or resident aliens classified as resident aliens solely under Section 7701(b)(1)(A)(ii).

h. Certain Separation Pay Plans. Reg. Section 1.409A-1(b)(9). Certain types of separation (severance) pay plans are totally excluded from deferred compensation while others are partially included or totally included by the regulation.

1) Definition. Separation pay means any deferral of compensation that will not be paid under any circumstances unless the service provider has had a separation from service including payments in the form of reimbursement of expenses incurred and the provision of in-kind benefits. Separation of service includes any termination of employment including death, disability, etc. Reg. Section 1.409A-1(h)(1)(i) and (m).

2) Separation Pay Excluded from Deferred Compensation.

(a) Collectively Bargained Separation Pay Plans. These are excluded from the definition of deferred compensation if the payment is because of involuntary separation from service or pursuant to a window program. The separation pay must be the subject of arm's length negotiation between employee representatives and one or more employers, contained in a collective bargaining agreement recognized by the Secretary of Labor and evidence good faith bargaining between the adverse parties over the separation pay to be provided under the agreement. Reg. Section 1.409A-1(b)(9)(ii).

(b) Non-Collectively Bargained Separation Pay Plans. Separation pay is not deferred compensation if paid upon involuntary separation from service or pursuant to a window program, if the separation pay does not exceed two times the lesser of the

service provider's annual compensation for the previous taxable year or the Section 401(a)(17) limits ($225,000 in 2007) and if paid no later than the end of the second taxable year of the service provider following the taxable year in which the separation of service occurs. Reg. Section 1.409A-1(b)(9)(iii). If some of the separation pay exceeds the compensation limit or is paid after the second taxable year, only the excess over these limits will be subject to Section 409A. Final Section 409A Regulations Preamble III J 2.

(c) Reimbursements and Certain Other Separation Payments. Reg. Section 1.409A-1(b)(9)(v).

(1) General Reimbursements. Excluded separation pay includes reimbursements for expenses not otherwise excludable from gross income (*e.g.*, medical and premium expenses under Sections 105 and 106) that the service provider could otherwise deduct under Section 162 or Section 167 as business expenses incurred in connection with the performance of services or of reasonable outplacement expenses and reasonable moving expenses actually incurred by the service provider and directly related to the termination of services for the service recipient. Such reimbursement would include any loss incurred by the service provider in the sale of a primary residence in connection with the separation from service. Expenses must be incurred no later than the end of the second taxable year after the year of separation from service and reimbursement must be made no later than the third taxable year after separation from service. Reg. Section 1.409A-1(b)(9)(v)(A) and (E).

(2) Medical Reimbursements. Taxable medical expenses are deferred from compensation to the extent that they would be deductible under Section 213 (ignoring the adjusted gross income limitation). Such reimbursement can continue through the applicable COBRA continuation period even though COBRA is not elected.

(3) In Kind Benefits and Direct Service Recipient Payments. In kind benefits or direct payments of goods or services from the service recipient to the service provider is not deferred compensation (*e.g.*, office space, the use of company cars or aircraft). Such direct payments must be made no later than the end of the second taxable year after the taxable year following separation from service. This exclusion applies whether the separation from service was voluntary or involuntary. This exclusion also applies up to the time limits even though the payments continue after the time limits (although the excess payments would be subject to Section 409A).

(d) Certain Limited Payments. If not otherwise excluded from separation pay, a taxpayer may treat a right or rights under a separation pay plan to a payment or payments as not providing for a deferral of compensation to the extent such payments in the aggregate do not exceed the applicable dollar amount under Section 402(g)(1)(B) for the year of separation from service ($15,500 in 2007). This covers other incidentals such as payment of tax return preparation.

3) Window Program. A window program provides for separation pay for a limited period of time (no greater than 12 months) to service providers who separate from service during that period. The program is not a window program if the service

recipient establishes a pattern of repeatedly offering separation pay windows. Reg. Section 1.409A-1(b)(9)(vi).

4) Involuntary Separation from Service Including Separation for Good Reason.

(a) Involuntary Separation from Service. The first two separation pay exclusions require involuntary separation from service. Separation is involuntary if due to the independent exercise of unilateral authority of the service recipient to terminate the service provider's services where the service provider was willing and able to continue performing services. This is based upon the facts and circumstances. A characterization of a separation by the parties as voluntary or involuntary is presumed to be correct but the presumption may be rebutted. Reg. Section 1.409A-1(n)(1).

(b) Separation for Good Reason. Reg. Section 1.409A-1(n)(2).

(1) General Rule. A separation for good reason will be deemed an involuntary separation if prespecified under the separation agreement and if separation is the result of material negative change such as duties to be performed, conditions under which such duties are to be performed, or compensation to be received for performing such services. Other factors include whether separation for good reason payments are to be made at the same time and in the same form as payments for involuntary separation, whether the service provider is required to give notice to the service recipient and the service recipient has a reasonable opportunity to remedy the condition. The agreement must be bona fide where the avoidance of Section 409A is not a purpose of the inclusion of these conditions in the plan or of the actions by the service recipient in connection with the satisfaction of those conditions. Reg. Section 1.409A-1(n)(2)(i).

(2) Safe Harbor. Reasonable cause will be treated as involuntary separation of service if the following conditions are met. Reg. Section 1.409A-1(n)(2)(ii). The plan must expressly contain these conditions, separation must occur during a predetermined limited period of time not exceeding two years and the amount, time and form of payment for good reason separation is substantially identical to that for involuntary separation. Good reason must be any one or more of material diminution in base compensation, authority, duties, responsibility, budget over which the service provider retains authority a material change in geographic location or any other action or inaction which is a material breach of the agreement with the service recipient.

5) Short Term Deferral May Apply. Involuntary separation from service can be a substantial risk of forfeiture. Reg. Section 1.409A-1(d)(1). Consequently, if the separation pay (even if it doesn't qualify under one of the other exclusions) is paid within the applicable two and a half month period, it will be excluded from Section 409A.

i. Certain Indemnification and Liability Insurance Plans. A plan does not provide for deferral of compensation to the extent it provides indemnification of, or the purchase of an insurance policy providing for payments of all or part of the expenses incurred or

damages paid or payable to a service provider with respect to a bona fide claim against the service provider or service recipient, including amounts paid or payable by the service provider upon the settlement of a bona fide claim, where such claim is based on actions or failures to act by the service provider in his or her capacity as a service provider of the service recipient. Reg. Section 1.409A-1(b)(10).

j. Legal Settlements. An agreement to which the service provider is a party does not provide for deferral of compensation to the extent that the agreement provides for amounts paid as settlements of awards resolving bona fide legal claims based on wrongful termination, employment discrimination, the FLSA, or worker's compensation statutes, including claims under applicable Federal, state, local or foreign law, or for reimbursements or payments of reasonable attorney's fees or other reasonable expenses incurred by the service provider related to such bona fide legal claim. Reg. Section 1.409A-1(b)(11).

k. Certain Educational Benefits. A plan in which a service provider participates does not provide for a deferral of compensation to the extent the plan provides for taxable educational benefits. This refers solely to benefits provided to a service provider, consisting solely of educational assistance for education of the service provider, as defined in Section 127(c) and the accompanying regulations, and does not refer to any benefits provided for the education of any other person, including any spouse, child, or other family member of the service provider. Reg. Section 1.409A-1(b)(12).

IV. WATCH OUT FOR THE PLAN AGGREGATION RULES

A. HOW SECTION 409A APPLIES TO DEFERRED COMPENSATION PLANS.

1. Participant By Participant.

Compliance with the rules of Section 409A is determined on a participant by participant basis. Thus, a violation of Section 409A by one participant does not affect other participants in the same plan. "The requirements of Section 409A are applied as if a separate plan or plans is maintained for each service provider." Reg. Section 1.409A-1(c)(1). However, the plan could have a defect which affects all participants (*e.g.*, an impermissible distribution option not included in the six distribution options included in the statute).

2. Service Recipient By Service Recipient.

If a service provider has deferred compensation plans with different service recipients (unrelated corporations or other entities) then for purposes of Section 409A, there are separate plans for each service recipient. Thus a violation of Section 409A by a service provider with one service recipient does not affect the plans with other service recipients.

In determining a service recipient, all persons and entities will be a single employer if considered as such under Section 414(b) (employees of a controlled group of corporations) or Section 414(c) (employees of partnerships, proprietorships, etc. under common control). Reg. Section 1.409A-1(g).

With regard to a service recipient, a service provider does not have to be an employee. The service provider can be an employee, director or independent contractor with regard to one or more service recipients. *See* Reg. Section 1.409A-1(f).

B. SERVICE PROVIDER AND PLAN AGGREGATION RULES.

1. General Concepts.

a. With regard to each service provider and each service recipient of the service provider, all plans within nine separate groups are treated as one plan for most purposes of Section 409A and the final regulation.

b. Thus, if one plan in an aggregation group fails for a service provider under Section 409A, all of such service provider's plans in the same aggregation group are taxable.

c. For example, presume that a service provider for the same service recipient participates in a 401(k) wrap plan, an excess benefit plan, a non-statutory stock option arrangement and a SAR arrangement and the stock option plan violates Section 409A because it is discounted. Under the aggregation rules, the stock option plan and the SAR plan are subject to income inclusion and the 20% additional tax under Section 409A (they are both in the stock rights aggregation group), but the 401(k) wrap (elective account balance aggregation group) and the excess benefit plan (non-account aggregation group) are not affected.

d. If a service provider has separate plans as an employee and independent contractor, these plans will not be aggregated. If the service provider is an employee and director with separate plans, there is no aggregation as long as the director arrangement is substantially similar to arrangements for other service providers who are only directors. Thus, to the extent that the service provider's director plan is not substantially similar to non-employee director plans, such plan will be treated as an employee plan and aggregated with the service provider's employee plan. Director plans and independent contractor plans (*e.g.*, consultant) are aggregated in the appropriate aggregation group. Reg. Section 1.409A-1(c)(2)(ii).

e. When a single plan includes both an account balance and a non-account balance arrangement, the final regulation requires that the two arrangements be bifurcated into separate plans under the FICA bifurcation rules of Reg. Section 31.3121(v)(2)-1(c)(1)(iii)(B).

2. Service Provider Aggregation Groups.

a. Service Provider Elective Account Balance Plans. Reg. Section 1.409A-1(c)(2)(i)(A). These are defined contribution plans which include elective deferrals of the participant (*e.g.*, under a 401(k) wrap plan).

b. Non-Elective Account Balance Plans. Reg. Section 1.409A-1(c)(2)(i)(B). These are defined contribution plans that include the service recipient's

contributions only. For this purpose, matching contributions of the service recipient are included.

c. Non-Account Balance Plans. Reg. Section 1.409A-1(c)(2)(i)(C). These are defined benefit plans.

d. Certain Separation Pay Plans. Reg. Section 1.409A-1(c)(2)(i)(D). These are separation pay plans involving involuntary separation from service (or separation for reasonable cause) under collectively bargained separation pay plans or non-collectively bargained separation pay plans under Reg. Section 1.409A-1(b)(9)(ii) and (iii).

e. Reimbursement Plans. Reg. Section 1.409A-1(c)(2)(i)(E). These involve deferrals of compensation under plans of the service recipient to the extent such amounts deferred consist of rights to in-kind benefits or reimbursement of expenses, such as membership fees, or expenses related to aircraft or vehicle usage, to the extent that the right to the in-kind benefit or reimbursement, separately or in the aggregate, does not constitute a substantial portion of either the overall compensation earned by the service provider for performing services for the service recipient, or the overall compensation received due to a separation from service.

f. Split Dollar Life Insurance Arrangements. Reg. Section 1.409A-1(c)(2)(i)(F). These cover split dollar arrangements whether or not grandfathered from the final split dollar regulations. The application of Section 409A to split dollar arrangements is discussed by the IRS in Notice 2007-34.

g. Foreign Deferred Compensation. Reg. Section 1.409A-1(c)(2)(i)(G). These are plans that provide for deferrals of amounts that would be treated as modified foreign earned income (meaning foreign earned income as defined under Section 911(b)(1) (without regard to Section 911(b)(1)(B)(iv) and without regard to the requirement that the income be attributable to services performed during the period described in Section 911(d)(1)(A) or (B)) if paid to the service provider at the time the amount is first deferred provided that substantially all the participants in such plan are non-resident aliens and that the service provider does not participate in a substantially identical domestic plan.

h. Stock Rights. Reg. Section 1.409A-1(c)(2)(i)(H). These are non-statutory stock option plans and SARs.

i. All Other Plans. Reg. Section 1.409A-1(c)(2)(i)(I). This is a catch-all category picking up any other types of deferred compensation plans not discussed above.

3. Impact of Plan Aggregation Rules.

a. As mentioned above, the aggregation rules come into play if one of the plans in which the service provider participates violates Section 409A causing income inclusion, additional 20% penalty tax and perhaps interest charges. Plans within the same aggregation group which did not independently violate Section 409A will nevertheless be taxed.

b. The plan aggregation rules could impact whether certain plans are eligible for the 30-day rule for initial deferral. Under Reg. Section 1.409A-2(a)(7), in the first year of eligibility of a service provider to participate in a deferred compensation plan, the service provider can make an initial election within 30 days after his eligibility date (rather than having to comply with the general rule that the election would be in the preceding taxable year). However, in determining whether the service provider is newly eligible, the plan aggregation rules apply. If he were participating already in another plan in the same aggregation group, the 30-day rule might not apply. The final regulation provides some nuances to the plan aggregation rule in this situation. Reg. Section 1.409A-2(a)(7)(ii) and (iii).

c. The final regulation specifies three plan termination provisions with the distribution of benefits to participants which would not violate the anti-acceleration rule. Reg. Section 1.409A-3(j)(4)(ix). Two of these plan termination provisions involve the plan aggregation rules.

1) Change of Control. A plan may permit the service recipient to take irrevocable action to terminate and liquidate a plan with regard to affected service providers within 30 days preceding or 12 months following a change of control event. All plans in the same aggregation group with regard to the affected service providers must also be terminated and liquidated. All amounts of compensation deferred under the terminated agreements are required to be distributed within 12 months of the date the service recipient takes the irrevocable action to terminate and liquidate the plan. Reg. Section 1.409A-3(j)(4)(ix)(B).

2) Termination for Three Years. If the termination and liquidation does not occur proximate to a downturn in the financial health of the service recipient, the service recipient can be granted discretion under the terms of the plan to terminate the plan but all plans in the same aggregation group must be terminated and liquidated at the same time. No payments are to be made other than those otherwise payable under the terms of the plan absent a termination of the plan within 12 months after the service recipient takes the necessary action to irrevocably terminate and liquidate the plan. All payments must be made within 24 months of such date. The service recipient must not adopt a new plan which would fall into the same aggregation group at any time for a period of three years after the date of termination and liquidation. Reg. Section 409A-3(j)(4)(ix)(C).

d. There probably are other areas in which the plan aggregation rule will have an impact. Unless expressly excepted by the final regulation, the plan aggregation rule applies.

4. Areas Not Subject To Plan Aggregation Rule.

a. Certain Grandfathering Purposes. The plan aggregation rules do not apply, in determining the amount which is grandfathered under a plan from Section 409A, for the purposes of actuarial assumptions and methods used in calculating the grandfathered amount. Accordingly, different reasonable actuarial assumptions and methods may be used to calculate the amounts deferred by a service provider in two different agreements, methods, programs, or other arrangements, each of which constitutes a non-account balance plan. Reg. Section 1.409A-6(a)(3)(v).

b. Material Modifications. In determining when a plan has been materially modified to lose grandfathering status, the plan aggregation rules do not apply. Reg. Section 1.409A-6(a)(4)(vii).

c. Establishment of a Plan. The plan aggregation rules do not apply if deferrals under an agreement, method, program, or other arrangement fail to meet the requirements for establishment of a plan (*e.g.*, the plan must be in writing). Reg. Section 1.409A-1(c)(3)(viii).

V. AVOID 409A PROBLEMS BY USING THE SHORT TERM DEFERRAL EXCEPTION

A. GENERAL RULE

There is no deferred compensation if the plan does not provide for a "deferred payment" and the service provider actually or constructively receives such payment on or before the last day of the later of the service provider's first taxable year (normally the calendar year) or the service recipient's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture. Reg. Section 1.409A-1(b)(4)(i). This is a surprisingly liberal rule. That amount of compensation could be deferred for several years but will not be subject to the statute if it is paid within two and a half months after the end of the appropriate taxable year in which the compensation is vested.

B. SPECIFICS OF THE GENERAL RULE

1. What Is a Deferred Payment?

If the plan provides for a deferred payment which could be later than the applicable two and a half month period, the short term deferral exclusion does not apply. Reg. Section 1.409A-1(b)(4)(i)(D).

a. A plan provides for a "deferred payment" if it specifies that the payment will be made after the applicable two and a half month period or would be paid upon the occurrence of any event that "will or may occur" later than the end of the applicable two and a half month period.

b. For example, assume that an employee has a legally binding right to a bonus on November 1, 2008 which is payable in a lump sum upon the employee's separation from service and the employee separates from service before March 15, 2009. Since separation of service could have occurred after March 15, 2009, this is a "deferred payment" not excluded under the short term deferral exception. Reg. Section 1.409A-1(b)(4)(iii), ex. 6.

c. There is not a "deferred payment" merely because the service provider or the service recipient has the option to defer the payment beyond the applicable two and a half month period unless such person actually makes such an election. Reg. Section 1.409A-1(b)(4)(i)(D).

d. A stock option or SAR otherwise subject to Section 409A will not qualify for the short term deferral exclusion if the service provider has a right to exercise the stock option or SAR after the applicable two and a half month period (even if he or she does exercise it within such period of time). Reg. Section 1.409A-1(b)(4)(i)(E).

2. Application to Life Annuity and Installment Payments.

It is possible to have a series of payments that overlap the applicable two and a half month period such as a life annuity or a series of installment payments that are not a life annuity.

a. In such a situation, as a general rule, since all of the payments may not be paid within the applicable two and a half month period, the plan is deemed to provide for a "deferred payment" which does not qualify for the short term deferral exclusion. Reg. Section 1.409A-1(b)(4)(i)(G).

b. In the case of a life annuity, the series of payments under the life annuity are always treated as a single payment. Reg. Section 1.409A-2(b)(2)(ii). Consequently, a series of payments pursuant to a life annuity will always be nonexcludable deferred payments.

c. With regard to a series of installment payments, as a general rule, they are treated as an entitlement to a single payment and thus would constitute a nonexcludable deferred payment. However, the final regulations state that the plan may provide that each installment payment is a separate payment if they are substantially equal periodic amounts to be paid over a predetermined period of years, except to the extent that any increase or decrease in the amount reflects reasonable earnings or losses through the date the amount is paid. Reg. Section 1.409A-2(b)(2)(iii). If the plan so provides that each installment is a separate payment, then the installments paid within the applicable two and a half month period would qualify for the short term deferral exclusion and the payments beyond the applicable two and a half month period would be subject to Section 409A.

3. When is a Right to Payment Vested for the Short Term Deferral Exclusion?

a. If the right to payment is subject to a substantial risk of forfeiture, the applicable taxable year from which to measure the two and a half month period is the year in which the right to payment is no longer subject to a substantial risk of forfeiture. Reg. Section 1.409A-1(b)(4)(i)(A).

b. If the right to payment is never subject to a substantial risk of forfeiture, the taxable year in which the service provider first has a legally binding right to receive the payment shall be the measuring year from which to apply the two and a half month period. Reg. Section 1.409A-1(b)(4)(i)(C).

c. For applying the two and a half month short term deferral rule, a payment is treated as actually or constructively received if it is includable in income under Section 83, the economic benefit doctrine, Section 402(b) or Section 457(f). Reg. Section 1.409A-1(b)(4)(i)(B). With regard to ineligible Section 457(f) plans where the employee has

taxable income upon vesting rather than actual payment, the regulations state that such inclusion in income is treated as payment of the amount for application of the short term deferral rule. Reg. Section 1.409A-1(a)(4).

4. Typical Application of Short Term Deferral Rule.

a. The most common application is to a bonus plan without a fixed payment date. If the bonus is paid by March 15 of the year immediately following the year in which the employee became entitled to the bonus, the short term deferral rule applies.

b. However, the short term deferral rule can apply to a payment made many years in the future. The preamble to the proposed regulations stated that this exception is intended to cover multi-year bonus arrangements where the right to compensation is or may be earned over multiple years, but is paid at the end of the earnings period (*e.g.*, a three-year bonus plan requiring services for three years with the bonus paid shortly after the end of the third year). Preamble to the Proposed Section 409A Regulations II B.

C. EXCEPTIONS TO THE TWO AND A HALF MONTH APPLICABLE PERIOD

The final regulations establish three exceptions to the rule that a payment must be made within the applicable two and a half month period. Reg. Section 1.409A-1(b)(4)(ii).

1. Administratively Impracticable.

If a payment otherwise qualifies for the short term deferral, payment can be made after the applicable two and a half month period if it was administratively impracticable to make the payment by the end of such period and if such impracticability was unforeseeable when the legally binding right to compensation arose. However, the payment must be made as soon as it is administratively practicable to do so. The administrative impracticability is not unforeseeable if based upon action or failure to act by the service provider such as the failure to provide necessary information or documentation.

2. Jeopardize Going Concern.

Likewise, the short term deferral exclusions still apply if the payment at the end of the applicable two and a half month period would have jeopardized the ability of the service recipient to continue as a going concern if the payment is made as soon as such jeopardy would no longer be effective.

3. Nondeductible Under 162(m).

Another exception is when it is reasonably anticipated that payment within the two and a half month applicable period would cause the service recipient not to be able to deduct the payment under Section 162(m), if at the date the legally binding right to the payment a reasonable person would not have anticipated that Section 162(m) would deny the deduction. In such event, the payment should be made as soon as possible after the application of Section 162(m) would not apply.

D. SHOULD THE SHORT TERM DEFERRAL EXCLUSION BE WRITTEN INTO THE PLAN?

The preamble to the proposed regulations stated that the short term deferral relevant deadline does not have to be written into the deferred compensation arrangement. The short term exception applies if the amount is actually paid by the appropriate deadline. Preamble to the Proposed Section 409A Regulations II B. The preamble to the proposed regulations pointed out that the failure to pay within the applicable two and a half month period would trigger Section 409A since there is no distribution date specified.

On the other hand, if the distribution date is specified and the actual payment is made after the specified date and after the applicable two and a half month period, even though Section 409A applies, the exceptions for delayed payments under Reg. Section 1.409A-3(d) could apply. In addition to the administratively impracticable and jeopardize the ability to continue as a going concern exceptions, that section also gives a broader exception for making the late payment no later than the later of the end of the calendar year of specified payment date or the fifteenth day of the third calendar month after the specified payment date.

Thus, the preamble for the proposed regulations suggests that it will often be appropriate to include the deadline for the short term deferral period in the written arrangement.

VI. JUST HOW DO THOSE SEPARATION PAY EXCLUSION RULES WORK?

A. GENERAL

Certain types of separation [severance] pay arrangements are totally excluded from the definition of deferred compensation, while others are partially included and partially excluded by the final regulations. There are four categories of separation pay arrangements: collectively bargained plans, non-collectively bargained plans, foreign separation pay plans, and reimbursement and certain other separation payments. Reg. Section 1.409A-1(b)(9).

B. COLLECTIVELY BARGAINED SEPARATION PAY PLANS

1. Separation pay is excluded if it is provided by a collectively bargained separation pay plan and covers only involuntary separation from service or is made pursuant to a window program. Reg. Section 1.409A-1(b)(9)(ii).

2. A collectively bargained separation pay plan is pursuant to an agreement that the Secretary of Labor determines to be a collectively bargained agreement and it was subject to an arm's length negotiation between employee representatives and one or more employers. In circumstances surrounding the agreement evidence good faith bargaining between adverse parties over the separation pay portion of the agreement.

C. NON-COLLECTIVELY BARGAINED SEPARATION PAY ARRANGEMENTS

1. Separation pay pursuant to a plan which is paid only upon involuntary separation from service or pursuant to a window program and is not part of a collectively bargained agreement. Reg. Section 1.409A-1(b)(9)(iii).

2. Said separation pay must not exceed two times the lesser of the service provider's annual compensation for the previous taxable year (adjusted for any increase during that year that was expected to continue indefinitely if the service provider had not separated from service) or the Section 401(a)(17) limits ($225,000 in 2007) for the taxable year of separation. The separation pay must be paid no later than the last day of the second taxable year following the taxable year in which the separation of service occurs.

D. FOREIGN SEPARATION PAY PLANS

1. A separation pay plan (including a plan providing for payments upon a voluntary separation from service) does not provide for deferred compensation to the extent the plan grants amounts of separation pay required to be provided under the applicable law of a foreign jurisdiction. Reg. Section 1.409A-1(b)(9)(iv).

2. A provision of foreign law shall be considered applicable only to foreign earned income as defined under Section 911(b)(1) without regard to Section 911(b)(1)(b)(iv) and without regard to the requirement that the income be attributable to services performed during the period described in Section 911(d)(1)(A) or (B) from sources within the foreign country that promulgated such law.

E. REIMBURSEMENTS AND CERTAIN OTHER SEPARATION PAYMENTS

1. General Reimbursements. Reg. Section 1.409A-1(b)(9)(v).

a. This applies to expense reimbursements regardless of whether separation from service was voluntary or involuntary.

b. This applies only to reimbursement expenses which would be taxable to the service recipient and does not apply to other expenses otherwise excludable from income such as health benefits under Section 105. Nontaxable benefits aren't covered by Section 409A.

c. Covered expenses are those which the service provider could otherwise deduct under Section 162 or Section 167 as business expenses incurred in connection with the performance of services (ignoring any applicable limitation based on adjusted gross income), or reasonable outplacement expenses and reasonable moving expenses actually incurred by the service provider and directly related to the termination of services from the service recipient.

d. Reasonable moving expenses includes the reimbursement of all or part of any loss the service provider actually incurs due to the sale of a primary residence in connection with the separation from service.

e. The expense must be incurred no later than the last day of the second taxable year of the service provider following the taxable year of separation from service. In addition, such reimbursement must be paid no later than the last day of the third taxable year of the service provider following the taxable year of separation from service.

2. Medical Benefits. Reg. Section 1.409A-1(b)(9)(v)(B).

a. This covers medical benefits provided upon voluntary and involuntary separation from service.

b. The medical expenses must be incurred by the service provider but not reimbursed by a person other than the service recipient and they must be allowable as a deduction under Section 213 (disregarding the provision that such expenses must exceed 7.5% of adjusted gross income).

c. The medical expenses must be incurred during the period of time to which the service provider would be entitled to COBRA coverage if the provider had elected such coverage and paid the applicable premiums.

3. In-Kind Benefits and Direct Service Recipient Payments

If the service recipient provides in-kind benefits to the service provider or if the service recipient directly pays the person providing the goods or services to the service provider, such in-kind benefits or direct payments will be excluded from deferred compensation if they would have been excluded from deferred compensation had the service provider been reimbursed for such benefits and services. Reg. Section 1.409A-1(b)(9)(v)(C).

F. DEFINITIONS

1. Window Programs

A window program provides for separation pay for a limited period of time (no greater than twelve months) to service providers who separate from service during that period. The program is not a window program if the service recipient establishes a pattern of repeatedly offering severance pay windows. Reg. Section 1.409A-1(b)(9)(vi).

2. Involuntary Separation From Service

a. Severance pay exclusions under collectively bargained plans or non-collectively bargained plans must be involuntary separation from service (unless a window program is involved). However, exclusion for general reimbursement expenses, medical benefits and in-kind benefits are excluded for both voluntary and involuntary separation from service.

b. An involuntary separation from service means separation due to the exercise of unilateral authority by the service recipient to terminate the service provider's services. The determination of involuntary separation from service is based upon the facts and circumstances. The characterization by the parties is presumed to be proper unless the facts and circumstances indicate otherwise. Reg. Section 1.409A-1(n)(1).

c. A separation from service for good reason will be deemed to be an involuntary separation from service for the separation pay exclusion if certain conditions are met.

1) Generally, the good reason must be prespecified in the plan. Good reason may constitute a material negative change such as duties to be performed, the conditions under which such duties are to be performed, or the compensation to be received for performing said services. Other factors include the extent to which the payments upon separation from service for good reason are in the same amount and are to be made at the same time and in the same form as payments available upon actual involuntary separation from service, and whether the service provider is required to give the service recipient notice of such good reason with a reasonable opportunity to remedy the situation. Reg. Section 1.409A-1(n)(2)(i).

2) The final regulations establish a safe harbor for separation from service for good reason. The safe harbor conditions are as follows. The separation from service must occur during a predetermined limited period of time not to exceed two years following the initial existence of one or more of the following conditions arising without the consent of the service provider: Reg. Section 1.409A-1(n)(2)(ii).

(a) A material diminution in the service provider's base compensation, authority, duties or responsibilities.

(b) A material diminution in the authority, duties, or responsibilities of the supervisor of the service provider (including a requirement that the service provider report to a corporate officer or employee instead of directly to the governing body of the employer).

(c) A material diminution in the budget over which the service provider retains authority.

(d) A material change in the geographic location at which the service provider must perform services.

(e) Any other action or inaction that constitutes a material breach by the service recipient of the agreement under which the service provider provides services.

(f) The amount, time and form of payment for separation from service must be substantially identical to that under actual involuntary separation from service and the service provider must be required to provide notice to the service recipient within ninety days after the initial existence of the good reason and the service recipient must be provided a period of at least thirty days to remedy the condition.

G. MISCELLANEOUS CONSIDERATIONS

1. When Severance Pay is Subject to Section 409A.

Severance payments will be subject to Section 409A if they are made upon a voluntary separation from service (except in connection with a window program) or if they neither meet the collectively bargained severance pay exception nor the limits upon other involuntary separation plans.

2. Severance Pay Exclusions Can Be Used In Combination.

Severance pay that qualifies for an exclusion as an involuntary separation from service or participation in a window program may be combined with a foreign separation pay plan or reimbursements and certain other separation payments. Reg. Section 1.409A-1(b)(9)(i). Preamble to the Final Section 409A Regulations III.J.1.

3. Severance Pay Cannot Be Used As a Deferred Compensation Substitute. Reg. Section 1.409A-1(b)(9)(i).

Any payment at separation from service that constitutes a substitution for, or replacement of, amounts deferred under a separate nonqualified deferred compensation plan will itself be deferred compensation subject to Section 409A. Reg. Section 1.409A-1(b)(9)(i).

4. Short Term Deferral May Apply.

Separation pay upon a voluntary termination of services or involuntary termination of services which would not otherwise meet the exclusion for severance pay can still be structured to meet the exclusion for the short term deferral.

5. Impact Upon Six Month Delay For Specified Employees.

Normally, deferred compensation payable to certain executives of public companies must be delayed six months. However, if the payment is pursuant to a separation pay plan which is excluded from Section 409A, the six month exclusion does not have to apply.

6. Separation Pay that Overlaps Ceiling.

Where a service provider is entitled to a payment that qualifies under the separation pay limit except that it exceeds the limit (*e.g.,* two times pay), only the excess over the limit will be subject to Section 409A. Preamble to the Final Section 409A Regulations III.J.2.

VII. IT IS OK TO DISTRIBUTE AFTER "SEPARATION FROM SERVICE" . . . WAIT A MINUTE, IT'S NOT THAT SIMPLE!!

A. SEPARATION FROM SERVICE.

1. Statutory General Rule.

The distribution event is the separation from service or, in the case of key employees of a corporation with publicly traded stock, six months after separation from service. Section 409A(a)(2)(A)(i) and (b)(i).

2. What Is Separation From Service For An Employee?

a. Generally. Separation from service occurs when the employee dies, retires, or otherwise has a termination of employment with the employer. Reg. Section 1.409A-1(h)(1)(i). This is determined based upon whether the facts and circumstances indicate that the employer and employee reasonably anticipated that no further services would be performed after a certain date or that the level of bona fide services the employee would perform (whether as an employee or as an independent contractor) would permanently decrease his or her services.

b. Leave of Absence Extension.

1) However, employment is not terminated while the individual is on military leave, sick leave or other bona fide leave of absence (i) if the period of such leave does not exceed six months, or (ii) if more than six months, so long as the individual retains a right to reemployment with the service recipient under an applicable statute or by contract.

2) If the leave exceeds six months and reemployment is not provided by applicable statute or contract, employment terminates at the expiration of six months.

3) There is an exception for substituting 29 months for six months if the leave is due to any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last at least six months and the employee cannot perform duties of his or her position of employment or any substantially similar position.

4) A leave of absence is bona fide only if there is a reasonable expectation that the employee will return.

c. Rebuttable Presumptions of Termination of Employment or Continuation of Employment. Reg. Section 1.409A-1(h)(1)(ii).

1) An employee is presumed to have separated from service when a level of bona fide services performed decreases to a level equal to 20% or less of the average level of services performed by the employee (whether as an employee or an independent contractor) during the immediately preceding 36-month period.

2) An employee will be presumed not to have separated from service when a level of bona fide services performed continues at a level that is 50% or more of the average level of services performed by the employee during the immediately preceding 36-month period.

3) No presumption applies to a decrease in the level of bona fide services performed to a level that is more than 20% and less than 50% of the average level of services performed during the immediately preceding 36-month period.

4) The presumption is rebuttable by demonstrating that the employer and employee reasonably anticipated that as of a certain date the level of bona fide services would be reduced permanently to a level less than or equal to 20% of the average level of bona fide services provided during the immediately preceding 36-month period. For example, the employer and employee reasonably anticipated that the employee would cease providing services, but that, after the original cessation of services, business circumstances such as termination of the employee's replacement caused the employee to return to employment.

5) A plan may treat another level of reasonably anticipated permanent reduction in the level of bona fide services as a separation from service, provided that the level of reduction required must be designated in writing as a specific percentage, and the reasonably anticipated reduced level of bona fide services must be greater than 20% but less than 50% of the average level of bona fide services provided in the immediately preceding 12 months

6) If an employee is on a paid bona fide leave of absence, the employee is treated as providing bona fide services at a level equal to the level of services that he would have been required to perform to receive the compensation pay with respect to such leave of absence. Periods during which the employee is on an unpaid bona fide leave of absence are ignored in calculating whether a subsequent termination of employment has occurred.

3. What Is Separation From Service For An Independent Contractor? Reg. 1.409A-1(H)(2).

a. In General. A separation from service occurs upon the termination of the last contract of the independent contractor with the service recipient if the termination constitutes a good faith and complete termination of the contractual relationship. Such expiration is not in good faith if there is an anticipated renewal of the contractual relationship. A service recipient is considered to anticipate the renewal of the contractual relationship with the independent contractor if it intends to contract again for services provided under the expired contract and neither has eliminated the independent contractor as a possible provider of services under any such new contract. Further, a service recipient is considered to intend to contract again under an expired contract if the service recipient's doing so is conditioned only upon incurring a need for the services, the availability of funds, or both.

b. Special Rule. A bright line rule is set by the regulation if the expiration of the contractual relationship results in no amount being paid to the independent contractor for at least 12 months and no services are performed during the 12-month period. Reg. 1.409A-1(h)(2)(ii).

B. SPECIFIED EMPLOYEE AND SIX MONTH DELAY.

1. Definition. A "specified employee" of a service recipient, any stock of which is publicly traded on the established securities market or otherwise, is an employee who meets the requirements of Section 416(i)(1)(A)(i), (ii) or (iii) at any time during the 12-month period ending upon the specified employee identification date. Reg. Section 1.409A-1(i)(1) (officer with compensation greater than $145,000, 5% owner or 1% owner with compensation greater than $150,000).

2. Compensation of Specified Employee for Definition Purposes. In identifying the compensation used to determine whether a specified employee meets the requirements of Section 416, the definition of compensation under Reg. 1.415(c)-2(a) is used, applied as if the service recipient were not using any safe harbor provided in Reg. 1.415(c)-2(d), were not using any of the special timing rules provided in Reg. 1.415(c)-2(e), and were not using any of the special rules provided Reg. 1.415(c)-2(g). Notwithstanding, the service recipient may elect to use any available definition of compensation under Section 415 and its regulations. A service recipient may elect to use such alternative definition regardless of whether another definition of compensation is being used for purposes of a qualified plan sponsored by the service recipient. However, once a list of specified employees becomes effective, the service recipient cannot change the definition of compensation for purposes of identifying specified employees for the period with respect to which such list is effective.

3. Specified Employee Identification Date. This is the date each year on which specified employees are determined. Reg. Section 1.409A-1(i)(3).

a. If the plan specifies no identification date, it will be December 31.

b. A service recipient may designate any other date as the specified employee identification date, but it must be used for all nonqualified deferred compensation plans and any change to the identification date may not be effective for a period of at least 12 months.

c. As a transition rule, any designation of a specified employee identification date made on or before December 31, 2007, may be applied to any separation from service occurring on or after January 1, 2005.

d. A service recipient may designate a specified employment identification date in each plan or in a separate document applicable to all plans.

4. Specified Employee Effective Date. Reg. Section 1.409A-1(i)(4).

a. This is the date that the specified employees determined on the identification date are effectively subjected to the six month rule.

b. If the plan is otherwise silent, the specified employee effective date is the first day of the fourth month following the identification date.

c. A service recipient may designate any date following the identification date as the effective date provided such date may not be later than the first day of the fourth month following the identification date, the same effective date applies to all nonqualified deferred compensation plans and any change in the effective date may not be effective for a period of at least 12 months.

d. The designation of an effective date can be included in each plan or in a separate document applicable to all plans.

e. As a transition rule, the specified employee effective date made on or before December 31, 2007, may be applied to any separation from service occurring on or after January 1, 2005.

5. Alternative Methods of Identifying Specified Employees. Reg. Section 1.409A-1(i)(5). A plan may provide for an alternative method to identify service providers subject to the six month rule provided that the alternative method is reasonably designed to include all specified employees, the alternative method is an objectively determinable standard providing no direct or indirect election to any service provider regarding its application, and the alternative method results in either all service providers or no more than 200 service providers being identified in the class as of any date.

6. Corporate Transactions. Reg. Section 1.409A-1(i)(6). There are special rules involving specified employees in mergers and acquisitions of public service recipients, mergers and acquisitions of nonpublic service recipients, spin-offs, public offerings and other corporate transactions.

7. Nonresident Alien Specified Employees. Reg. Section 1.409A-1(i)(7). In determining whether a non-resident alien is a specified employee under Section 416, the regulations permit the service recipient to not count as compensation of such non-resident alien amounts which are excludable from income under Reg. Section 1.415(c)-2(g)(5)(i).

8. How is the Six Month Delay for Specified Employees Accomplished? The plan must provide the manner in which the six month delay will be implemented. Reg. Section 1.409A-3(i)(2).

a. The general rule is that payments to a specified employee cannot be made prior to six months after separation from service except upon the death of the service provider. No acceleration is permitted during said six month period even if the service provider becomes disabled, there is a change of control event or an unforeseeable emergency.

b. However, payments may be made during the six-month period for the following situations which would be permitted as accelerations under the final regulation: domestic relation order, conflict of interest and payment of employment taxes.

c. The six month rule is met if the payments to the specified employee to which he is entitled during the first six months are paid on the first day of the seventh month or if each payment to which the specified employee is entitled during the first six months is itself delayed six months. The service recipient may retain discretion as to which

method of satisfying the six month rule may be used. However, the service provider may not have such discretion.

d. The six month rule applies only to specified employees on the date of separation from service. This is true even though the service provider at the separation from service date would have been a specified employee at the next specified employee effective date. Furthermore, the six month rule will apply to a service provider who is a specified employee on the date of separation from service although he would have ceased to be a specified employee at the next specified employee effective date.

VIII. HOW DO I INITIALLY DEFER COMPENSATION UNDER THE NEW RULES

A. DEFER TIME AND FORM OF PAYMENT

An election to defer an amount includes an election both as to the time and form of payment. It does not include an election as to the medium of payment (*e.g.,* cash or property). An election is treated as made as of the date the election becomes irrevocable. Reg. Section 1.409A-2(a)(1).

B. DATE OF INITIAL DEFERRAL BY SERVICE PROVIDER

1. Prior Year Election.

Generally, the election must be made prior to the close of the preceding taxable year of the service provider. Reg. Section 1.409A-2(a)(3). In the case of a service recipient with a fiscal year other than calendar year, the plan may provide that the service provider elect deferral before the close of the preceding fiscal year of the service recipient but only for service recipient bonuses payable after the service provider's service during the next fiscal year (this fiscal year exception does not apply to calendar year bonuses or salary of service provider which otherwise would be paid during the service recipient's fiscal year). Reg. Section 1.409A-2(a)(6).

2. Thirty Days After Eligibility.

The service provider may make the election within thirty days after he or she becomes eligible to participate in the plan with respect to compensation paid for service performed subsequent to the election. Reg. Section 1.409A-2(a)(7)(i).

a. If the compensation is earned based upon a specified performance period and the deferral election in the first year of eligibility is after the beginning of the service period, the election will be deemed to apply to compensation paid for services performed subsequent to the election if the election applies to a portion of the compensation equal to the total amount of compensation for the service period 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. Reg. Section 1.409A-2(a)(7).

b. In determining whether a service provider is newly eligible to participate in the plan, the plan aggregation rules apply. However, the expansion under the final

regulations to nine different aggregation groups should make it easier to qualify for the initial eligibility deferral. Also, the final regulations make it easier to qualify for the initial eligibility rule in two situations.

1) Where the service provider has received the final payments from a deferred compensation plan and is not eligible to continue under that plan, such service provider may still be treated as initially eligible to participate in a new plan established after the final payment of the old plan.

2) With regard to a service provider who has ceased to be eligible to participate in a plan but has retained a balance in the plan, if he returns to eligibility in the same plan and has been inactive in that plan for at least twenty-four months, then the initial eligibility rules will apply. Reg. Section 1.409A-2(a)(7)(ii).

c. With regard to an excess benefit plan which does not involve an election by the service provider (*e.g.,* an excess defined benefit plan), then the initial eligibility rule (from which the thirty day election period would run) will begin with the taxable year of the service recipient immediately following the taxable year in which the service provider accrued a benefit under the plan. Reg. Section 1.409A-2(a)(7)(iii). This was necessary for excess benefit plans since, quite often, it is not until the next year that the employer is able to determine whether an excess benefit has accrued to an employee in a particular year.

3. <u>Performance Based Compensation.</u>

a. With regard to performance based compensation involving a performance period of at least twelve months, the service provider may elect deferral no later than six months before the end of the performance period. Reg. Section 1.409A-2(a)(8). In order to qualify for the performance based election, the service provider must perform services continuously from the later of the beginning of the performance period or from the date the performance criteria has been selected by the service recipient.

b. In no event, may the election be made if the performance criteria has been met and the amount of compensation is readily ascertainable. If a portion of the compensation is readily ascertainable, then it may be bifurcated between the portion that is readily ascertainable and the amount that is not readily ascertainable.

c. Performance based compensation is compensation where the amount of, or entitlement to, the compensation is contingent on the satisfaction of pre-established organizational or individual performance criteria relating to the performance period of at least twelve consecutive months. The performance criteria must be in writing no later than ninety days after commencement of the period provided that the outcome is substantially uncertain at the time the criteria is established. Reg. Section 1.409A-1(e)(1).

d. Performance based compensation does not include any amount that would be paid regardless of performance or based upon a level of performance that is substantially certain to be met at the time the criteria is established.

e. Performance based compensation may be based upon subjective performance criteria which relates to the performance of the participant service provider, a group of service providers that includes the participant service provider, or a business unit for which the participant service provider provides services and a determination that the subjective performance criteria have been met is not made by the participant service provider or a family member (as defined in Section 267(c)(4) applied as if the family of an individual includes the spouse of any member of the family), or a person under the effective control of the participant service provider or such a family member and no amount of the compensation of the person making such determination is effectively controlled in whole or in part by the service provider or such family member. Reg. Section 1.409A-1(e)(2).

4. Special Initial Deferral Rules.

a. With respect to short term deferrals.

Generally, initial deferral election rules would not apply to compensation subject to a substantial risk of forfeiture which would not constitute deferred compensation under the short term deferral rule once the service provider has commenced performing services. However, should the service provider want to defer the short term deferral amounts, the service provider may elect to make such deferral subject to a substantial risk of forfeiture under the same rules for a redeferral election applied as if the amount deferred was paid on the date the risk of forfeiture would last (*e.g.,* election at least twelve months before the lapse of the risk of forfeiture and the deferral for at least five years except in the case of change of control). Reg. Section 1.409A-2(a)(4).

b. With respect to certain forfeitable rights. If a service provider has a legally binding right to a payment in a subsequent year that is subject to a condition requiring the service provider to continue to provide services for a period of at least twelve months from the date the service provider obtains the legally binding right to avoid forfeiture of the payment, an election to defer such compensation may be made on or before the thirtieth day after the service provider obtains the legally binding right to the compensation, provided that the election is made at least twelve months in advance of the earliest date at which the forfeiture condition could last. Reg. Section 1.409A-2(a)(5). The preamble to the proposed regulations pointed out that this is a reasonable accommodation to service recipients granting certain *ad hoc* awards such as restricted stock units that often are subject to a requirement that the service provider continue to perform services for at least twelve months. Preamble to the Proposed Section 409A Regulations II.F. The final regulations make an exception to the minimum twelve month vesting rule in case the plan provides for vesting upon death, disability or change of control within the twelve month period.

C. INITIAL DEFERRAL ELECTION FOR NON-ELECTIVE DEFERRED COMPENSATION

If the deferred compensation is provided by the service recipient without election by the service provider (*e.g.,* SERP), then the time and form of payment must be set at the later of when the service provider first has a legally binding right to the compensation under the plan

or, if later, the time the service provider would be required under Section 409A to make an election if the service provider were provided with an election. Reg. Section 1.409A-2(a)(2).

IX. I DEFERRED BUT WANT TO REDEFER—HOW?

A. <u>REDEFERRAL ELECTIONS TO CHANGE TIME AND FORM OF PAYMENTS</u>

1. <u>Conditions For Redeferral.</u>

A plan may permit a subsequent election to redefer a payment or to change the form of a payment that is subject to the following conditions: Reg. Section 1.409A-2(b)(1).

a. The plan requires that the election not take effect until at least twelve months after the date on which the election is made.

b. Except for payments made on the account of disability, death or an unforeseen emergency, the plan requires that the payment with respect to which such election is made be deferred for a period of at least five years from the date such payment would otherwise have been paid.

c. The plan requires that any such election be made not less than twelve months before the date the payment is scheduled to be made.

2. <u>Definition of Payments For Purposes of Subsequent Changes in Time or Form of Payment.</u>

a. Generally, the term “payment” refers to each separately identified amount to which a service provider is entitled to payment under a plan on a determinable date, and includes amounts applied for the benefit of the service provider. That amount is separately identified only if the amount may be objectively identified under a non-discretionary formula. Payments may be paid in cash, in-kind, or represent a reduction of deferred compensation in exchange for other benefits. Reg. Section 1.409A-2(b)(2)(i).

b. A life annuity is treated as a single payment on the date the life annuity begins. A life annuity means a series of substantially equal periodic payments payable not less frequently than annually for the life (or the life expectancy) of the service provider or a series of substantially equal periodic payments payable not less frequently than annually, for the life (or life expectancy) of the service provider, followed upon the death or end of the life expectancy of the service provider by a series of substantially equal periodic payments, payable not less frequently than annually, for the life (or life expectancy) of the service provider’s designated beneficiary. Changing life annuities is not a deferral as long as the annuities are actuarially equivalent applying reasonable actuarial assumptions. Thus, the twelve month election and five year deferral rules apply from the first date of the life annuity payment. Reg. Section 1.409A-2(b)(2)(ii)(A).

1) The final regulations go into considerable detail of when annuities are actuarially equivalent. Certain features are disregarded such as term certain features, pop-up provisions, cash refund features, social security or railroad retirement leveling features, and cost of living index.

2) Subsidized joint and survivor annuities are treated as actuarially equivalent to a single life annuity provided that, neither the annual lifetime annuity benefit nor the annual survivor benefit available under the joint survivor annuity is greater than the annual lifetime annuity benefit available under the single life annuity.

3. Beneficiaries.

The change of the identity of a beneficiary does not constitute a change in time or form of payment merely because the election changes the life expectancy calculations. Furthermore, under a deferred compensation plan, elections by the beneficiary as well as the service provider are subject to the redeferral rules. Reg. Section 1.409A-2(b)(3).

4. Domestic Relations Orders.

A domestic relation order does not constitute a time and form of payment change requiring a new redeferral election with regard to the alternate payee. However, any change with regard to the service provider will be subject to the redeferral rules. Reg. Section 1.409A-2(b)(4).

5. Coordination of Deferrals With Prohibition Against Acceleration of Payments.

The final regulations allow a change in the form of payment which results in a more rapid schedule as long as it complies with the redeferral rules. For example, a ten year installment payment treated as a single payment can be changed to a lump sum payment as long as the election is made at least twelve months before the first installment and the deferral is at least five years from the first installment. Reg. Section 1.409A-2(b)(5).

6. Application of Deferral Rules From Multiple Payment Events.

If a plan permits payment upon each of a number of potential permissible payment events, the redeferral elections are applied separately to each event. Reg. Section 1.409A-2(b)(6). For example, under a plan which provides a lump sum payment to the employee at the earlier of age 65 or separation from service, the employee may elect by his 64th birthday to receive a lump sum payment at the earlier of age 70 or separation from service.

B. EXCEPTIONS TO REDEFERRAL RULES

1. Delay of Payments Under Certain Circumstances Which Do Not Require the Redeferral Rules to be Met. Reg. Section 1.409A-2(b)(7).

A plan may provide, or be amended to provide, that payment not be made upon a designated payment date because of any of the following circumstances which will not be treated as a redeferral subject to the twelve month election and five year redeferral rules:

a. Payments subject to Section 162(m).

A plan may provide that a payment may be delayed to the extent the service recipient reasonably anticipates that if the payment were made as scheduled, the service recipient's deduction with respect to such payment would not be permitted due to the application of Section 162(m). However, the payment is to be made either during the service provider's first taxable year in which the service recipient reasonably anticipates or should reasonably anticipate that if the payment is made during such year the deduction of such payment will not be barred by the application of Section 162(m) or during the period beginning with the date of the service provider's separation from service and ending on the later of the last day of the taxable year of the service recipient in which the service provider separates from service or the fifteenth day of the third month following the service provider's separation from service.

b. Payments that would violate federal security law or other applicable law.

A payment may be delayed where the service recipient reasonably anticipates that the making of the payment will violate federal securities laws or other applicable law; provided that the payment is made at the earliest date at which the service recipient reasonably anticipates that the making of the payment will not cause such a violation. Other applicable law does not involve inclusion in the gross income or penalty provisions under the Internal Revenue Code.

c. Other events and conditions.

A service recipient may delay a payment upon such other events and conditions as the commissioner may prescribe in generally applicable guidance published in the Internal Revenue Bulletin.

2. USERRA.

The redeferral election rules do not apply to the extent an election to change the time or form of payment of deferred compensation is required to satisfy the Uniform Services Employment and Reemployment Rights Act of 1994. Reg. Section 1.409A-2(b)(8).

X. TO WHAT EXTENT ARE MY OLD PLANS GRANDFATHERED?

A. EFFECTIVE DATE AND GRANDFATHERING RULES.

1. When Did Section 409A Become Effective?

a. The statute applies to (a) amounts deferred in taxable years beginning after December 31, 2004, and (b) amounts deferred in taxable years beginning before January 1, 2005, if the plan under which the deferral was made is materially modified after October 3, 2004. Reg. Section 1.409A-6(a)(1)(i).

b. A nonqualified deferred compensation arrangement subject to a collective bargaining agreement in effect on October 3, 2004, is not required to comply with Section 409A on or before the earlier of the date on which the collective bargaining agreement terminates (ignoring post-October 3, 2004 extensions) or December 31, 2009. Reg. Section 1.409A-6(a)(1)(ii).

2. Grandfathered Deferrals.

Section 409A does not apply to amounts deferred before January 1, 2005 (or to earnings on such deferrals after 2004), if (a) the service provider or employee had a legally binding right to be paid the amount and (b) the right to the amount was earned and vested. Reg. Section 1.409A-6(a)(2).

a. Legally Binding Right and Earned and Vested. An amount is earned and vested only if the amount is not subject to a substantial risk of forfeiture (as defined in Reg. Section 1.83-3(c)) or a requirement to perform further services.

1) Note that the broader definition of substantial risk of forfeiture of Section 83 is used for grandfathering purposes and not the more restrictive definition under Section 409A. For example, a covenant not to compete can be a substantial risk of forfeiture under Section 83 but not Section 409A.

2) If the service recipient retained discretion to reduce the amount of deferred compensation, the service provider does not have a legally binding right to the amount on December 31, 2004.

3) As a minor exception, an amount to which the service provider has a legally binding right before January 1, 2005, but for which the service provider must continue performing services to retain the right only through the completion of a payroll period which includes December 31, 2004, the requirement to perform services will be ignored for purposes of effective date.

4) A stock option or SAR that on or before December 31, 2004, was immediately exercisable for cash or substantially vested property is treated as earned and vested regardless of whether the right would terminate upon service provider's separation from service.

5) If the principal amount is grandfathered but the future earnings were not vested on December 31, 2004, the earnings will be a separate right and not grandfathered.

b. Calculation of Deferred Compensation as of December 31, 2004.

1) Non-Account Balance Plans. Reg. Section 1.409A-6(h)(3)(i).

(a) This equals the present value as of December 31, 2004, of the amount to which the service provider would be entitled under the plan if the service provider voluntarily terminated services without cause on December 31, 2004, and received a payment of the benefits available under the plan on the earliest possible date allowed under the plan following the termination of services, receiving the benefits in the form with maximum value, to the extent the right to the benefit is earned and vested.

(b) The grandfathered amount may be increased to equal the present value of the benefit the service provider actually becomes entitled to, determined under the plan as in effect as of October 3, 2004, without regard to any further services rendered after December 31, 2004, or any other events affecting the amount of entitlement to the benefit (other than a participant election with respect to the time or form of available benefit)—*e.g.*, subsidized benefit.

(c) Reasonable actuarial assumptions must be used in determining the grandfathered benefit.

2) Account Balance Plans. The portion of the service provider's account balance as of December 31, 2004, which was earned and vested plus any future contributions to the account which were earned and vested as of December 31, 2004, to extent actually contributed. Reg. Section 1.409A-6(a)(3)(ii).

3) Equity Base Compensation Plans. The amount deferred as of December 31, 2004, is calculated the same way as the account balance plan for the amount available to the service provider (or that would be available to the service provider if the right were immediately exercisable) to the extent the right is earned or vested. For this purpose, the payment available to the service provider excludes any exercise price or other amount which must be paid by the service provider. Reg. Section 1.409A-6(a)(3)(iii).

4) Earnings. Any earnings on grandfathered amounts include only income (whether actual or notional) attributable to such grandfathered amounts or to such income. Similarly, an increase in the amount of payment available pursuant to a grandfathered stock option, SAR or other equity-based compensation is itself grandfathered (*e.g.*, appreciation in the underlying stock or accrual of other earnings such as dividends). With regard to a non-account balance plan, earnings include the increase, due solely to the passage of time, in the present value of future payments on deferred compensation which was grandfathered. Thus, an increase due to the shortening of the discount period or the service provider's increasing age is grandfathered. However, increases in potential benefits under a non-account plan due to an application of an increase in compensation after 2004 to a final average pay plan or subsequent

eligibility for an early retirement subsidy do not constitute grandfathered earnings. Reg. Section 1.409A-6(a)(3)(iv).

5) Plan Aggregation. For grandfathering purposes, the plan aggregation rules for plans of the same type apply. There is a limited exception for non-account plans where they can be treated separately for the purpose of applying reasonable actuarial assumptions. These can be different for each plan. Reg. Section 1.409A-6(a)(3)(v).

B. MATERIAL MODIFICATION EXCEPTION TO GRANDFATHERING. Section 409A(D)(2)(B).

If amounts are deferred before January 1, 2005, and there is a material modification after October 3, 2004, of the plan under which the deferral is made, the deferrals "shall be treated as amounts deferred in the taxable year beginning on or after" January 1, 2005.

1. When Is A Plan Materially Modified?

A modification is material if a benefit or right existing as of October 3, 2004, is materially enhanced or a new material benefit or right is added. Such benefit, enhancement or addition is a material modification whether it occurs pursuant to a plan amendment or the employer's exercise of discretion under the terms of the plan. Reg. Section 1.409A-6(a)(4)(i).

a. It is a material modification if the service recipient exercises discretion to accelerate vesting of a benefit under a plan to a date on or before December 31, 2004.

b. An addition of a new payment option (*e.g.*, 20% haircut provision) is a material modification.

c. A plan amendment or exercise of the discretion under the terms of the plan that materially enhances an existing benefit or right or adds a new benefit or right is a material modification even if the enhanced or added benefit would be permitted under Section 409A.

2. Modifications Which Are Not Material. Reg. Section 1.409A-6(A)(4)(I).

a. The service recipient exercises discretion over the time and manner of payment of a benefit to the extent such discretion is provided under the terms of the plan as of October 3, 2004.

b. With respect to an account balance plan, to change a notional investment measure to, or to add, an investment measure that qualifies as a predetermined actual investment within the meaning of Reg. Section 31.3121(v)(2)-1(d)(2) or reflect a reasonable rate of interest. A rate is reasonable if fixed for no longer than five years if reasonable at the beginning. Reg. Section 1.409A-6(a)(4)(iv).

c. It is not a material modification for a service provider to exercise a right permitted under the plan as in effect on October 3, 2004.

d. The amendment of a plan to bring the plan into compliance with the provisions of Section 409A.

e. A reduction of an existing benefit.

f. The establishment of a contribution to a domestic rabbi trust from which benefits are to be paid, provided that such contribution would not otherwise cause an amount to be included in the service provider's gross income.

g. Compliance with a domestic relations order with respect to payments other than to the service provider or an amendment to the plan authorizing such payments.

h. Modification of a plan providing a life annuity form of payment to permit an election between the existing life annuity form and other forms of annuity payments that would be treated as a single form of payment with the existing life annuity form of payment under Reg. Section 1.409A-2(b)(2)(ii).

i. Modification to add a limited cash-out feature consistent with the anti-acceleration exception of Reg. Section 1.409A-3(j)(4)(v).

j. Modification, extension or renewal of a stock right if such would not be treated as a grant of a new stock right under Reg. Section 1.409A-1(b)(5)(v)(C). Reg. Section 1.409A-6(a)(4)(v).

3. Adoption of a New Arrangement.

The grant of an additional benefit under an existing arrangement that consists solely of a deferral of additional compensation not otherwise provided under the plan as of October 3, 2004, will be treated as a material modification only as to the additional deferral of compensation, if the plan explicitly identifies the additional deferral of compensation and provides that the additional deferral of compensation is subject to Section 409A. Thus an amendment to conform with Section 409A for deferrals after 2004 is not a material modification if it is clear that the amendment does not apply to the grandfathered amounts. Reg. Section 1.409A-6(a)(4)(ii).

4. Suspension or Termination of Plan.

a. With regard to grandfathered amounts, a cessation of deferrals under, or termination of, a plan, pursuant to the provisions of such plan, is not a material modification.

b. However, amending an arrangement to provide participants an election whether to terminate participation in the plan constitutes a material modification of the plan.

5. Rescissions of Modifications.

a. If a plan is modified which would inadvertently constitute a material modification, it is not considered a material modification of the grandfathered plan to the extent that the modification is rescinded by the earlier of the date before the right is exercised (if the change grants a discretionary right) or the last day of the taxable year during which such change occurred. Reg. Section 1.409A-6(a)(4)(vi).

b. The final regulation gives an example of a material modification which would add an election to change the time and form of payment but the modification is rescinded before the end of the calendar year and no change in time or form of payment was made pursuant to the modification before the rescission.

6. No Plan Aggregation.

For these modification rule purposes, each nonqualified deferred compensation plan stands on its own for a service provider with no aggregation (*e.g.*, one nonqualified defined contribution plan may be materially modified without tainting other nonqualified defined contribution plans). Reg. Section 1.409A-6(a)(4)(vii).

XI. WHAT SHOULD I DO NOW BEFORE 2008?

1. Determine What Plans Provide Deferred Compensation.

Obviously, all employment agreements and traditional deferred compensation plans should be reviewed. Remember that the definition of "plan" and "deferred compensation" is very broad. Unless they fall within some exclusion, Section 409A might apply to compensation incentive plans (even though they are short term of one, two or three years), severance agreements, rights accruing upon change of control, SARs, stock options, ineligible 457(f) plans and phantom stock plans. This can be a time consuming and difficult process.

2. Identify Grandfathered Deferred Compensation and (Perhaps) Preserve Grandfathering.

If earned and vested compensation is deferred under a plan in existence prior to 2005 which does not meet the requirements of Section 409A, it is usually desirable to preserve the grandfathered status. Thus it is necessary to determine the amount of deferral under each plan which was earned and vested as of December 31, 2004, using guidance given by the IRS and to maintain separate accounting for the grandfathered amounts. It is also important not to materially modify the plan with regard to the grandfathered deferred compensation. In order to accomplish this, the plan should be amended no later than December 31, 2007, to freeze the grandfathered benefits as of December 31, 2004.

3. Performance-Based Compensation Elections.

If bonuses are tied to performance-based criteria for periods after the effective date, the criteria set out in the proposed regulations must be met to preserve the deferment.

4. Good Faith Operational Compliance.

During calendar years 2005, 2006 and 2007, before the plan is amended to comply with Section 409A or to qualify for one of the exclusions from the definition of deferred compensation, the plan must be operated in good faith in accordance with the provisions of the statute, Notice 2005-1, any other appropriate notices, the proposed regulations and the final regulations. This transitional rule allows the plan to be operated before it is actually amended to comply with the statute without violating Section 409A. It is important to scrupulously meet the good faith standard since, at this time, there is no self-correction procedure in place to allow a taxpayer to avoid the 20% penalty tax and other provisions of the statute in case of inadvertent violation of the good faith compliance rule. Members of the ABA Section on Taxation have urged the IRS to establish a self-correction procedure but this has not yet (if ever) occurred.

5. Determine Whether Special Transition Rules Should Be Adopted.

All stock options and SARs which are not grandfathered from Section 409A should be reviewed to determine whether the exercise price is less than the fair market value at the date of grant. Section 409A can be avoided if the option or SAR is amended to increase the exercise price to original fair market value (not available for certain Section 16 officers under IRS Notice 2006-79, Section 3.07).

Changes in time and form of payment can be made before the end of the year without violating the deferral, redeferral and anti-acceleration rules, if the employee elects to take advantage of the new optional time and form of payment (not applicable for amounts otherwise payable in 2007 or to accelerate the payments otherwise due in the future years to 2007).

6. Make Amendments To Take Advantage of Short Term Deferral Rule.

If desirable, a plan can be amended to qualify for the short-term deferral rule and thereby completely avoid application of Section 409A (*e.g.*, annual bonus plans, Section 457(f) plans; etc.).

7. Unlink Payments of 401(k) Wraparound and Excess Benefit Plans.

If there are any nonqualified plans linked to a qualified plan, the plan should be amended to provide that any future payments after 2007 from the nonqualified portion of the linked plans be made independently to qualify with the Section 409A deferral, redeferral and anti-acceleration rules independent of the form of payment chosen by the participant under the applicable qualified plan.

8. Adopt the Amendments No Later Than December, 31, 2007.

As part of the good faith compliance transition rule, formal amendments to qualify the plan under Section 409A or to exclude it from the provisions of Section 409A must be adopted no later than December 31, 2007. Fortunately, the preamble to the final regulations state that the plan does not have to be amended retroactive to January 1, 2005 and does not have to reflect actions taken under the transition rules. Preamble XIII B. Consequently, assuming

there has been good faith operational compliance, the plan can be amended effective January 1, 2008 ignoring all prior transactions. However, the taxpayer must be able to demonstrate that the plan was operated in compliance with the transitional guidance, including demonstrating that amounts were deferred or paid in compliance with the transition rules.

9. Employee Consent.

Existing deferred compensation arrangements are contracts, the amendment of which would require the consent of the employee on the other side of the contract. Even if the employer has the right to unilaterally change the arrangement, such rights almost certainly will not apply without the consent of the employee to amounts already deferred. Consequently, bringing the new statute, the potential income tax liabilities and suggested amendments to the attention of the employee should be done as soon as possible.

Disclosures:

This outline is not intended to be tax advice and this outline was not intended or written by the author to be used and it cannot be used by any taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer. Any tax advice contained in this outline may be held by Treasury or the IRS to have been written to support, as that term is used in Treasury Department Circular 230, the promotion or marketing of the transactions or matters addressed by such advice. A taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

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