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Additional Analysis of Final 409A Regulations

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Major References: [Final Treasury Regulations Under Code Section 409A](#);

[IRS Notice 2007-34](#).

Related Reports: [07-41](#), [07-34](#), [07-38](#), [06-131](#), [06-118](#), [06-114](#), [06-96](#), [06-70](#), [06-44](#), [06-16](#), [06-06](#), [06-02](#), [04-173](#)

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SEE THE CIRCULAR 230 DISCLAIMERS APPENDED TO THE CONCLUSION OF THIS WASHINGTON REPORT.

This Washington Report fulfills our promise to provide a detailed analysis of the just issued Code section 409A final regulations. (See our Bulletins Nos. 07-41 and 07-38.) IRS Notice 2007-34, which was released in conjunction with the final regulations, provides specific guidance regarding the application of section 409A to split-dollar life insurance arrangements. (A more detailed analysis of Notice 2007-34 was provided in our Bulletin No. 07-41.)

Statutory Overview

The deferred compensation rules under Code section 409A generally apply to any agreement or arrangement that provides for the deferral of compensation (including those covering only one person). Certain tax-favored retirement plans (e.g., qualified retirement plans, 403(b) plans) and bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plans are statutorily excepted from the new rules.

409A imposes three new key requirements, which must be satisfied both in form and operation: (1) distribution restrictions, (2) acceleration restrictions, and (3) election restrictions. The new requirements are in addition to the existing rules, and do not replace them. As a result, a deferred compensation plan will need to satisfy both the new rules and the existing rules (e.g., constructive receipt, economic benefit and Code section 83 rules, to the extent applicable).

The distribution restrictions provide that deferred compensation cannot be distributed any earlier than one of six specified events - (1) separation from service (for key employees of publicly-traded companies, the deferred compensation must not be distributed for at least six months after separation from service); (2) disability (as narrowly defined in the statute); (3) death; (4) a specified time (or fixed schedule specified under the arrangement as of the date of deferral), but not an event; (5) a change in the ownership or effective control of the corporation or in the ownership of a substantial portion of the assets of the corporation (to the extent provided by the Treasury); or (6) the occurrence of an unforeseeable emergency (as narrowly defined in the statute).

The acceleration restrictions provide that the deferred compensation cannot be accelerated except as otherwise provided in regulations. For example, so-called "haircut" provisions, which allow for the accelerated distribution of deferred compensation if there is a reduction in the amount payable (e.g., a 10% reduction), are no longer be permissible.

The election restrictions impose requirements with respect to both the timing of a participant's initial deferral election as well as the designation of the time and form of distributions. With respect to a participant's initial deferral election, the initial election to defer compensation for services performed during a taxable year generally must be made no later than the close of the preceding taxable year. There are two statutory exceptions. First, in the case of a new plan or a participant first becoming eligible under a plan, the initial deferral election generally must be made within 30 days of initial eligibility. Second, the deferral election with respect to "performance-based compensation" can be made at least 6 months before the end of the performance period, provided such performance period is at least 12 months.

Under the new rules, the time and form of distributions must be designated at the time of the initial deferral election. However, the new rules allow for changes that further delay or change the form of payment if certain requirements are met (e.g., the change is made at least one year in advance of the originally scheduled payment date and the change delays the originally scheduled payment date at least five years).

409A also imposes new rules regarding the funding of deferred compensation arrangements. Assets that are located outside of the United States or that become restricted to the payment of deferred compensation in connection with a change in the employer's financial health would be taxable to the participants when transferred outside of the United States or set aside. In addition, the new rules require all deferred compensation to be reported on IRS Form W-2 or Form 1099 when deferred, even though the compensation may not yet be taxable.

There are significant adverse tax consequences if the new requirements are not satisfied: (1) all deferred compensation must be included in income in the current taxable year to the extent not subject to a substantial risk of forfeiture (including deferrals in prior years); (2) an additional tax equal to the interest, using the IRS' underpayment rate plus 1%, that would have been imposed during the deferral period if the deferred compensation had been includible in income when first deferred (or not subject to a substantial risk of forfeiture); and (3) an additional tax equal to 20% of the deferred compensation.

The new rules statutorily apply to amounts deferred on or after January 1, 2005. Amounts deferred (earned and vested) before January 1, 2005 are not subject to the new rules unless there is a material modification of the arrangement on or after October 3, 2004.

Final Regulations

(1) Overview of Final Regulations:

The final regulations retain the general structure and format of the proposed regulations, but include significant modifications and clarifications. Overall, the changes are generally favorable compared to the proposed regulations and should provide employers with additional flexibility in complying with 409A. The final regulations package was over 400 pages in length. This Bulletin is intended to provide a general overview of the final regulations and summarize some of the more significant changes included in the final regulations. As a result, this Bulletin does not discuss all of the changes and should not be viewed as a comprehensive analysis of the final regulations.

(2) General Effective Date Issues

(a) Effective Date of Final Regulations:

The final regulations are effective April 17, 2007 (the date they were published in the Federal Register) and are generally applicable for taxable years beginning on or after January 1, 2008. The final regulations do not extend the existing transition rules or period beyond December 31, 2007, and therefore, all plans subject to the new rules will have to be fully compliant, in both operation and documentation, by the end of 2007.

(b) Written Plan Requirements:

Under the new rules, all plans subject to 409A must be in writing. The final regulations provide that a plan must specify the following items in order to satisfy the written plan requirement to the extent these items are applicable:

- (i) the amount which the service provider has a right to be paid (or, in the case of an amount determinable under an objective, nondiscretionary formula, the terms of such formula);
- (ii) the schedule or triggering events that will result in a payment of the amount;
- (iii) the six-month delay requirement for payments to specified employees of publicly-traded companies upon separation from service (no later than the time such provision may be applicable); and
- (iv) the conditions under which a deferral election may be made.

These items represent the minimum provisions that must be in the plan document in order to satisfy the written plan requirement. Other optional provisions permitted under the final regulations may need to be in the plan document if a plan elects to include such provisions.

The final regulations also expressly provide that the written plan does not need to specify the conditions under which an accelerated payment will be made, provided that the taxpayer must be able to demonstrate that the acceleration of a payment complies with the requirements of 409A and the final regulations. The final regulations also confirm that the terms of a plan document may be contained in more than one document.

The documentation requirements must be satisfied no later than December 31, 2007. However,

the preamble to the final regulations states that any amendments are required only to bring the document into compliance effective January 1, 2008, and are not required to reflect any amendments made or actions taken under the transition rules to the extent such amendments or actions do not affect the plan's compliance with 409A for periods on or after January 1, 2008. Plan sponsors must also be able to demonstrate that the plan was operated in compliance with the transition guidance, including that amounts were deferred or paid in compliance with the transition rules.

The final regulations also expressly provide that general provisions of the plan that purport to nullify noncompliant plan terms, or to supply any specific terms required by 409A will be disregarded. Accordingly, "savings" clauses will not work for purposes of complying with 409A.

Although the IRS and Treasury have taken a minimalist approach to the written plan requirements, plan sponsors may want to include additional provisions in a plan document for reasons other than 409A. For example, plan sponsors may want to consider amending their plans retroactive to the effective date of 409A (January 1, 2005) as part of their process of documenting compliance during the transition period. Similarly, plan sponsors may want to include other provisions in the plan for enforcement or contractual reasons.

(3) Plans Subject to 409A

(a) General:

Code section 409A generally applies to all nonqualified deferred compensation plans, which are defined broadly to include any plan (including those covering only one person) that provides for the deferral of compensation. Certain tax-favored plans, like qualified retirement plans (401(a)) and tax-deferred annuities (403(b)) are statutorily excepted. In addition, bona fide vacation, sick leave, compensatory time, disability pay and death benefit plans are statutorily excepted. The final regulations also clarify that certain medical reimbursement plans are excepted, but only if the arrangements provide benefits that are excludable from taxable income under Code sections 105 and 106.

(b) Arrangements with Independent Contractors:

The final regulations retain the special rule in the proposed regulations which provides that 409A does not apply to deferred payments to independent contractors if certain requirements are satisfied, the most significant of which is that the independent contractor provide "significant services" to two or more unrelated service recipients. The final regulations also retain the safe harbor in the proposed regulations which provides that an independent contractor is deemed to provide significant services to two or more unrelated service recipients if the revenues generated from any service recipient do not exceed 70 percent of the independent contractor's total revenues. The final regulations add a new safe harbor which provides that an independent contractor that has actually met the 70 percent threshold in the three immediately previous years is deemed to meet the 70 percent 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.

Many insurance agents are independent contractors who sell the products of more than one insurance carrier. It is possible that in some years more than 70% of their earnings would come from only one company, so they would not qualify for the new safe harbor, unless they had actually met the 70 percent threshold in the three immediately preceding years and did not know or have reason to anticipate that they would not meet the threshold in the current year.

(4) Plans Providing for the Deferral of Compensation

(a) Legally Binding Right:

The final regulations slightly modify the definition of the term "deferral of compensation" to provide that a plan provides for the deferral of compensation only 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 year (emphasis added). This change is intended to clarify that if a payment could be made after the end of the taxable year in which the legally binding right is created, it constitutes a deferral of compensation even though it could also be paid in the same taxable year. For example, a payment upon separation from service could be made in the current year or a later year, depending on when the service provider separates from service. The final regulations also clarify that a legally binding right to an amount that will be excluded from taxable income when and if received does not constitute a deferral of compensation, unless the service provider has received the right in exchange for, or has the right to exchange the right for, an amount that will be includible in income (other than due to participation in a cafeteria plan described in Code section 125).

Consistent with the proposed regulations, the final regulations provide that a legally binding right to compensation may exist even where the right is subject to conditions, including conditions that constitute a substantial risk of forfeiture. In contrast, a service provider does not have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated by the service recipient or other person after the services creating the right to the compensation have been performed (emphasis added). The regulations provide further that such negative discretion will be recognized unless it lacks substantive significance, or is available or exercisable only upon a condition.

(b) Exceptions and Special Rules:

Consistent with the proposed regulations, the final regulations include a number of exceptions and special rules for purposes of determining whether an arrangement provides for the deferral of compensation, including, but not limited to, the following:

(i) Short-term Deferrals:

(A) Exception Retained:

The final regulations retain the exception for short-term deferrals, which provides that a deferral of compensation generally does not occur if an amount is actually or constructively received by the service provider by the later of: (I) the date that is 2-1/2 months from the end of the service provider's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture, or (II) the date that is 2-1/2 months from the end of the service recipient's year in which the amount is no longer subject to a substantial risk of forfeiture. However, the final regulations do liberalize the standard under which a payment can be a short-term deferral even if it is delayed due to unforeseeable events. Under the new standard, a payment may be delayed where the payment would jeopardize the ability of the service recipient to continue as a going concern (as opposed to would jeopardize the service recipient's solvency, which was the standard under the proposed regulations).

(C) Substantial Risk of Forfeiture - Involuntary and Good Reason

Separations:

The basic definition of the term "substantial risk of forfeiture" was retained without modification in the final regulations. Compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. However, in a change from the proposed regulations, the final regulations explicitly provide that an amount will be considered subject to a substantial risk of forfeiture if the amount is conditioned on a service provider's involuntary separation from service without cause, provided there is a substantial risk that the service provider will not be involuntarily separated from service without cause.

The final regulations also provide that certain voluntary separations from service for good reason may be treated as involuntary separations under the final regulations. A voluntary separation from service for good reason will be treated as an involuntary separation if the voluntary separation effectively constitutes an involuntary separation from service. The "good reason" generally must be defined to require actions taken by the service recipient resulting in a material negative change to the service provider in the service relationship, such as the duties to be performed, the conditions under which such duties are to be performed, or the compensation to be received for performing such services. This determination is generally based on the relevant facts and circumstances. However, the final regulations contain a safe harbor under which a voluntary separation will be treated as an involuntary separation if the following conditions are satisfied:

(I.) the separation from service must occur during a pre-determined 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:

- (a) a material diminution in the service provider's base compensation;
- (b) a material diminution in the service provider's authority, duties, or responsibilities;
- (c) a material diminution in the authority, duties, or responsibilities of the supervisor to whom the service provider is required to report, including a requirement that a service provider report to a corporate officer or employee instead of reporting directly to the board of directors of a corporation (or similar governing body with respect to an entity other than a corporation);
- (d) a material diminution in the budget over which the service provider retains authority;
- (e) a material change in the geographic location at which the service provider must perform services; or
- (f) any other action or inaction that constitutes a material breach by the service recipient of the agreement under which the service provider provides services;

(II.) the amount, time and form of payment upon the separation from service must be substantially identical to the amount, time and form of payment payable due to an

actual involuntary separation from service, to the extent such right exists; and

(III.) the service provider must be required to provide notice to the service recipient of the existence of the good reason condition within a period not to exceed 90 days of the initial existence of the condition, upon the notice of which the service recipient must be provided a period of at least 30 days during which it may remedy the condition and not be required to pay the amount.

(ii) Stock Rights:

The final regulations significantly modify the special rules for stock options and stock appreciation rights ("SARS"), which are collectively referred to under the regulations as "stock rights."

(A) Stock Options: Consistent with the proposed regulations, the final regulations except incentive stock options (ISOs) under Code section 422, and the grant of an option under an employee stock purchase plan described in Code section 423. The final regulations also provide that a nonqualified stock option to purchase service recipient stock is excepted if 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 option does not include any feature for the deferral of compensation.

(B) SARs:

The final regulations also retain the exception for certain SARs, which applies if 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 an amount specified on the date of grant of the SAR, the exercise price may never be less than the fair market value of the underlying stock on the date the right is granted, and the SAR does not include any feature for the deferral of compensation.

(C) Modifications and Extensions:

The final regulations also retain the general rules regarding modifications and extensions, with several significant changes. Under the general rules, a modification includes any change in the terms of a stock right that may provide the holder with a direct or indirect reduction in the exercise price regardless of whether the holder in fact benefits from the change in terms. Any modification is considered the granting of a new stock right, which must satisfy the conditions described above as of the date of the modification in order to be excepted from 409A.

The final regulations also provide that the following actions do not constitute modifications: (I) to change the terms of a stock right to shorten the exercise period, (II) to add a feature to allow the holder to tender previously acquired stock to pay the exercise price, (III) to withhold or have withheld stock to facilitate the payment of employment taxes or required withholding taxes from the exercise of the stock right, (IV) for the grantor to exercise discretion specifically reserved under the stock right with respect to the transferability of the stock right, and (V) to accelerate the time at which a stock right may be exercised if the stock right is not immediately exercisable in full. The final regulations also provide that the substitution and assumption of stock rights will not be treated as the grant of a new stock right or change in the form of payment if the requirements of Regulations section 1.424-1 are satisfied (subject to certain modifications prescribed in the final regulations).

An extension generally includes any provision to the holder of an additional period of time within which to exercise the stock right beyond the time originally prescribed under the terms of the

stock right, 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. The final regulations provide that if a stock right is extended, the stock right is treated as having had an additional deferral feature from the date of grant. As such, the stock right would not qualify for the exceptions described above, and therefore, would be subject to Code section 409A from the original grant date. In most cases, traditional stock rights would not satisfy the new requirements (e.g., providing a specified payment date).

In a significant change from the proposed regulations, the final regulations provide that it is not an extension if the exercise period of a stock right is extended to a date no later than the earlier of the latest date upon which the stock right could have expired by its original terms under any circumstances or the 10th anniversary of the original date of grant of the stock right. The final regulations also provide that it is not an extension if the exercise period is extended when the exercise price equals or exceeds (i.e., underwater options) the fair market value of the service recipient stock.

(D) Determining Fair Market Value:

(I) Readily Tradable Stock:

The final regulations generally follow the guidance in the proposed regulations with respect to the valuation of stock that is readily tradable on an established securities market. In general, alternative valuation methods can be used as long as the valuation is based upon the contemporaneous prices established in the securities market. For example, fair market value can 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 basis using actual transactions in such stock as reported by the market and consistently applied. The regulations provide further that fair market value can also be based upon an average selling price during a specified period that is within 30 days before or after the grant. However, an averaging period can be used only if the service recipient makes an irrevocable commitment to grant the stock right before the beginning of the specified period. To satisfy this requirement, the service recipient must designate the recipient of the stock option, the number of shares subject to the stock option, 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.

(II) Not Readily Tradable Stock:

The final regulations also generally follow the guidance in the proposed regulations with respect to the valuation of stock that is not readily tradable with several modifications and clarifications. Under the general rule, a service recipient must value the stock based on a reasonable application of a reasonable valuation method. The regulations clarify that it is not necessary that a taxpayer demonstrate that the value was determined by an independent appraiser. In addition, the final regulations modified the list of factors to be considered in valuing stock to include consideration of any recent equity sales made by the corporation in arm's-length transactions. The final regulations retain the rebuttable presumption that a valuation of stock reflects the fair market value if the valuation is based upon an independent appraisal, a generally applicable repurchase formula that would be treated as fair market value under Code section 83, or, in the case of illiquid stock of a start-up corporation, a valuation by a qualified individual or individuals applied at a time that the corporation did not otherwise anticipate a change in control event or public offering of the stock. The presumption is rebuttable only by a showing that the valuation is grossly unreasonable.

With respect the presumption applicable to illiquid start-up corporations, the final regulations provide that it will not apply if, at the time the valuation is made, the service recipient or service provider reasonably anticipates that the service recipient will undergo a change in control event in the next 90 days or an initial public offering within the next 180 days. This is a change from the proposed regulations, which generally imposed a twelve month period. The final regulations also clarify the standard that applies for purposes of determining whether an individual is "qualified" to provide a valuation, which is whether a reasonable individual, upon being apprised of such person's relevant knowledge, experience, education and training, would reasonably rely on the advice of such person with respect to valuation in deciding whether to accept an offer to purchase or sell the stock being valued. The final regulations also clarify that significant experience generally means 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.

(E) Service Recipient Stock:

The final regulations significantly expand the types of stock that qualify as service recipient stock. For this purpose, a service recipient includes the entity for which the services are performed and any other corporation in a chain of organizations with a controlling interest from the parent to the direct service recipient. The service recipient can include any other organization above the direct service recipient in the chain, but not any organizations below the direct service recipient (i.e., the stock of a subsidiary will not qualify as service recipient stock with respect to the parent). In addition, the stock of a sister/brother related entity will not qualify as service recipient stock. A controlling interest is generally defined as a 50% or greater ownership interest. In addition, where the use of stock is based upon a legitimate business criteria, the threshold can be lowered to at least 20 percent. As an example, the proposed regulations indicate that the lower 20 percent threshold can be used with respect to a joint venture if the applicable entity owns at least a 20 percent interest in the joint venture.

The proposed regulations provided that service recipient stock could only include common stock that is readily tradable on an established securities market, or if none, that class of common stock having the greatest aggregate value of common stock issued and outstanding. In a significant departure from the proposed regulations, the final regulations generally provide that any class of common stock may be used, regardless of whether another class of common stock is publicly traded or has a higher aggregate value outstanding. In addition, the final regulations also allow stock to qualify as service recipient stock even if it has a preference with respect to liquidation rights, but it cannot have any other preferences such as a preferential right to dividends.

The final regulations also include an anti-abuse provision which is intended to cover structures, transactions, or grants intended to provide deferred compensation, rather than compensation related to an increase in the true enterprise value of the service recipient. In this regard, the final regulations expressly provide that, if an entity becomes a member of a group of corporations or other entities treated as a single service recipient, and the primary source of income or value of such entity arises from the provision of management services to other members of the service recipient group, then any stock rights issued with respect to such entity are presumed to be issued for purposes of avoiding the application of 409A.

(iii) Restricted Property:

The final regulations retain the rule that a grant of restricted property generally will not constitute a deferral of compensation. However, the final regulations also retain the special rule that the

grant of a legally binding right to receive vested property in a future year does constitute a deferral of compensation. The final regulations clarify that a vested right to receive nonvested property in a future year does not constitute deferred compensation. Thus, restricted stock units (RSUs) will generally be subject to 409A, while restricted stock will not (assuming the requirements prescribed above are satisfied). However, RSUs may qualify for the short-term deferral exception if the stock is actually paid within the relevant 2-1/2 month period following the vesting of the RSUs. The final regulations also clarify that an election between compensation alternatives, none of which provides for a deferral of compensation, will not cause the election to be subject to 409A. For example, a choice between an award of restricted stock or excepted stock options will not be subject to 409A.

(iv) Separation Pay Arrangements:

The final regulations generally retain the exceptions provided in the proposed regulations for certain "separation pay arrangements," which are generally defined as arrangements providing payments upon a separation from service. However, the final regulations include a number of significant modifications and clarifications with respect to separation pay arrangements.

The final regulations clarify that separation pay refers only to compensation to which the service provider's right is conditioned upon a separation from service (including separation from service due to death or disability) and not to compensation the service provider could receive without separating from service. For example, separation pay would not include an amount that is also payable upon a change in control, as a result of an unforeseeable emergency, or on a date certain. The final regulations also provide that the various exceptions for separation pay arrangements can be used in combination so that if an amount can be excluded under two or more exceptions, the amount only has to be taken into account under one of the exceptions and other amounts can be excluded under the other exception(s).

The final regulations retain the rule that separation pay arrangements providing for short-term payments upon an involuntary separation from service or participation in a window program are exempt to the extent certain timing and amount limitations are satisfied. Under the proposed regulations, if the timing or amount limitations were exceeded, none of the payments qualified for the exception. In a significant change, the final regulations provide that the exception continues to apply up to the applicable limits. The applicable limits are: (I) the amount of payments excluded cannot exceed two times the service provider's annual compensation (for the calendar year before the year in which the service provider separates from service), or, if less, two times the limit on annual compensation that may be taken into account for qualified plan purposes under Code section 401(a)(17) (\$225,000 for calendar year 2007), and (II) the payments must be made by no later than the end of the second calendar year following the year in which the service provider separates from service. This is an important modification from the proposed regulations. Under this modification, the amounts below the limits are not subject to 409A and can be paid out as scheduled, even if the service provider is subject to the six-month delay for specified employees of publicly-traded companies. Any amounts in excess of the limits are subject to 409A unless they qualify for another exception.

The exception for short-term payments generally applies only if the payment is on account of the service provider's involuntary separation from service. As discussed above with respect to the short-term deferral exception, if certain requirements are satisfied, certain voluntary separations from service for good reason are treated as involuntary separations from service for purposes of 409A, including this exception for separation pay arrangements.

The final regulations also provide that certain reimbursement arrangements related to a separation from service are excepted if the arrangements cover only reimbursements that are otherwise

excludible from gross income, reimbursements for expenses that the service provider can deduct under Code section 162 or 167, outplacement expenses, moving expenses, medical expenses, as well as other types of payments that do not exceed the Code section 402(g) limits (i.e., \$15,500 for 2007) (an increase from the flat \$5,000 limit in the proposed regulations) in the aggregate during any given taxable year. The final regulations, like the proposed regulations, require that the eligible expenses must be incurred by the service provider no later than the end of the second year following the year in which the separation from service occurs. However, the final regulations extend the period during which a service provider can receive a reimbursement payment by providing that such payments must be made no later than the end of the third year following the separation from service. This extension applies only to reimbursements of expenses and does not apply to in-kind benefits, which must continue to be provided by the end of the second year following the separation from service. In addition, like the short-term payment exception, the final regulations provide that the reimbursement exceptions apply to the qualifying reimbursements available during the limited period of time, even if the plan extends beyond the limited period of time.

(v) Wrap Plans:

The final regulations retain, with certain modifications and clarifications, the special rules that will allow certain wrap plans (i.e., nonqualified plans linked to qualified plans) to continue to operate if certain requirements are satisfied, which may require changes to existing arrangements. For example, the regulations provide that wrap 401(k) plans can be maintained if, among other requirements, the actions or inactions of a participant under the 401(k) plan with respect to elective deferrals do not result in an increase in the amounts deferred under the nonqualified plan in any calendar year in excess of the deferral limits under Code section 402(g) (i.e., \$15,500 in 2007). The final regulations clarify that the wrap plan relief provided for elective deferrals (including designated Roth contributions) and matching type contributions, each up to the Code section 402(g) dollar limit on elective deferrals, are separate, additive limits and are not a single, coordinated limit. The final regulations also clarify that the Code section 402(g) limits are increased by the limit on catch-up contributions under Code section 414(v) (\$5,000 for 2007), which applies to participants age 50 and older.

The final regulations also expand the relief to apply to changes to elections under a Code section 125 cafeteria plan, provided certain requirements are satisfied.

(vi) Non-Taxable Benefits:

The final regulations clarify that a legally binding right to receive a nontaxable benefit does not provide for a deferral of compensation for 409A purposes, unless the service provider has received the right in exchange for, or has the right to exchange the right for, an amount that will be includible in income (other than due to participation in a cafeteria plan described in Code section 125).

(vii) Legal Settlements:

The final regulations provide that 409A generally does not apply to settlements or awards resolving bona fide legal claims based on wrongful termination, employment discrimination, the Fair Labor Standards Act, or worker's compensation statutes, even where settlements or awards pursuant to such claims are treated as compensation for Federal income tax purposes. However, the final regulations provide that the exception covers only rights arising from the bona fide claim, and is not intended to allow such settlements or awards to act as substitutes for, or to allow for the restructuring of, preexisting deferred compensation subject to 409A.

(viii) Educational Benefits:

The final regulations generally provide an exception for rights to educational benefits, where the benefits consist solely of educational assistance (as defined for purposes of Code section 127(c)) provided solely for the education of the service provider.

(ix) Indemnification Arrangements

The final regulations generally provide that 409A does not cover amounts received under an indemnification arrangement for expenses incurred as a result of a legal claim for damages related to the service provider's performance as a service provider (to the extent permissible under applicable law). This exclusion also applies to a right to liability insurance coverage for such expenses.

(x) Foreign Arrangements:

The final regulations, like the proposed regulations, provide guidance with respect to the application of Code section 409A to various foreign arrangements. Under the general rule, a foreign arrangement is not subject to section 409A to the extent the compensation subject to the arrangement would not have been includible in gross income for Federal tax purposes if it had been paid to the service provider at the time that the legally binding right to the compensation first arose or, if later, the first time that the legally binding right was no longer subject to a substantial risk of forfeiture, and the service provider was a nonresident alien at such time. The final regulations also include certain modifications and clarification with respect to the special provisions for foreign arrangements.

(xi) Partners and Partnerships:

Notice 2005-1 and the preamble to the proposed regulations provided interim guidance regarding the application of Code section 409A to arrangements between partnerships and partners. In the preamble to the final regulations, the Treasury and the IRS indicate that they are still analyzing this area and that the final regulations do not provide any additional guidance. Accordingly, taxpayers can continue to rely on the interim guidance in Notice 2005-1 and the preamble to the proposed regulations until further guidance is issued. However, the preamble to the final regulations did provide additional guidance regarding arrangements providing for payments that qualify as payments to a partner under Code section 1402(a)(1), which provides an exception from the Self-Employment Contributions Act (SECA) tax for payments to a retired partner, provided that certain conditions are met.

(5) Plan Aggregation Rules

Consistent with the proposed regulations, the final regulations provide that the requirements of 409A are generally applied as if a separate plan is maintained for each service provider. For this purpose, the final regulations aggregate the following nine categories of plans separately (a significant expansion from the four categories prescribed under the proposed regulations - namely, account balance plans, nonaccount balance plans, separation pay plans and all other plans):

- (a) elective account balance plans;
- (b) nonelective account balance plans;
- (c) nonaccount balance plans;

- (d) separation pay arrangements;
- (e) split-dollar life insurance arrangements (see *Washington Report 07-41*);
- (f) reimbursement plans;
- (g) stock rights;
- (h) foreign plans; and
- (i) all other plans.

The plan aggregation rules are primarily relevant for purposes of determining liability if the 409A requirements are not satisfied, the initial deferral election rules for new plans and participants and for purposes of applying the plan termination rules. For example, if a stock right that is subject to 409A does not satisfy all of the requirements with respect to a particular service provider, all of the stock rights granted to the service provider that are subject to 409A are aggregated and are treated as having not satisfied the requirements. In addition, one of the plan termination rules allows a plan to be terminated and the amounts distributed to the participants if certain requirements are satisfied, including that all of the plans in the same category are also terminated and no new plans within the same category are established by the service recipient within 3 years of the termination. As a result, the expansion of the categories of plans under the aggregation rules should be beneficial in determining liabilities and for other purposes under 409A.

Under these plan aggregation rules, a violation by one participant generally does not cause the entire plan to fail to comply with Code section 409A. However, representatives of the Treasury and IRS have indicated informally that there may be circumstances where a violation that does not directly affect all participants taints the entire plan and causes adverse tax consequences for all participants (e.g., where the operations of the plan indicate that amounts are currently available to all participants notwithstanding the terms of the plan).

(6) Initial Deferral Election Rules

(a) General Rules:

Under the general rule, a service provider must make a deferral election in the taxable year before the year in which the services are performed. An election to defer an amount includes an election both as to the time and form of the payment. In addition, an election is treated as made as of the date the election becomes irrevocable. The final regulations provide that evergreen deferral elections can satisfy the deferral election rules if the elections become irrevocable with respect to future compensation no later than the last permissible date an affirmative initial deferral election could have been made with respect to such compensation.

(b) Nonelective Arrangements:

The initial deferral election rules do not apply to nonelective arrangements, which are defined as arrangements that do not provide the participant with any election with respect to the amount deferred or the time and form of payment. In addition, an arrangement will qualify as a nonelective arrangement only if it specifies the time and form of payment no later than the time the service provider obtains a legally binding right to the compensation. If a participant is provided with an election with respect to

the time and form of payment, the election must be made in accordance with the initial deferral election rules.

(c) Performance-Based Compensation:

There is an exception to the initial deferral election rules for performance-based compensation, which provides that the initial deferral election with respect to such compensation can be made at least 6 months before the end of the performance period, provided such performance period is at least 12 months and the election is made before the amount is readily ascertainable (note that the proposed regulations included the standard "before the amounts become substantially certain to be paid").

Under the final regulations, performance-based compensation is defined as compensation the amount of which or the entitlement to which is contingent on the satisfaction of preestablished organizational or individual performance criteria. The final regulations provide that performance-based compensation generally can be based on subjective performance criteria, provided that the determination of whether the subjective performance criteria have been met is not made by the service provider or a member of the service provider's family, or a person the service provider supervises or over whose compensation the service provider has any control. The performance criteria must be established within 90 days of the commencement of the period of service to which the criteria relates, provided that the outcome is substantially uncertain at the time the criteria are established.

Performance-based compensation can be based solely upon an increase in the value of the service recipient, or the stock of the service recipient, after the date of grant or award. However, the final regulations, like the proposed regulations, provide that this exception does not apply with respect to an election to defer amounts payable under a stock right (e.g., arrangements that provide for the deferral of stock option gains). The final regulations expressly provide that a stock right with a deferral feature is subject to Code section 409A from the date of grant, and therefore, in order to comply, such an arrangement would be required to specify a permissible payment time and a form at the date of grant.

The final regulations clarify that a plan will qualify for the performance-based exception even if it provides for automatic payment to occur upon a death, disability or a change in control event (provided all other requirements are satisfied).

(d) First Year of Eligibility:

There is an exception to the initial deferral election rules in the case of a new plan or a participant first becoming eligible under a plan, which provides that the initial deferral election must generally be made within 30 days of initial eligibility and can only apply to compensation for services performed after the election. The final regulations, like the proposed regulations, provide that the plan aggregation rules apply for purposes of this exception. As a result, if a participant was previously eligible to participate in another plan of the same type (e.g., elective account plan, nonaccount plan, separation pay plan or other plan), the participant will not be eligible for this exception with respect to the new plan.

The final regulations include a new rule for nonelective excess benefit plans (as defined in the regulations), which provides that a participant will be treated as initially eligible as of the first day of the taxable year immediately following the first year the participant accrues a benefit under the plan so that the participant can elect the time and form of payment for benefits accrued in the first year within the first 30 days of the immediately following year.

(e) Special Rule With Respect to Certain Forfeitable Rights:

The final regulations, like the proposed regulations, include an exception for certain forfeitable rights that are granted during the middle of a taxable year. The general initial election deferral rules would require a deferral election to have been made prior to the beginning of such taxable year. To address this situation, the final regulations provide that where a grant of nonqualified deferred compensation is subject to a forfeiture condition requiring the continued performance of services for a period of at least 12 months, the initial deferral election may be made no later than 30 days after the date of grant, provided that the election is made at least 12 months in advance of the end of the service period. Thus, if an item of compensation is subject to at least a 13-month vesting period, a deferral election can be made during the calendar year in which it is first granted, provided the requirements for this special rule are satisfied.

(f) Special Rule With Respect to Fiscal Year Compensation:

The final regulations retain the guidance with respect to service recipients (e.g., employers) with fiscal years and who base compensation on service periods that are coextensive with one or more of the service recipient's consecutive fiscal years and where no amount of such compensation is payable during the service period. In that case, the final regulations provide that the initial deferral election rules are generally satisfied if the initial election to defer the fiscal year compensation is made on or before the end of the fiscal year immediately preceding the first fiscal year in which any services are performed for which the compensation is paid. Where the compensation is not specifically based upon the service recipient's fiscal year as the measurement period, the regular initial deferral election rules apply.

(g) Special Rules With Respect to Commissions:

The final regulations include modifications to the proposed regulation provisions addressing the timing of deferral elections with respect to commissions. The proposed regulations generally treated the services related to the commission payment as performed in the year in which the customer remits payment to the service recipient. This rule was retained and a new rule was added under which the taxable year in which the transaction is consummated can be substituted for the year in which the customer remits payment. The final regulations also include a new rule for investment commissions, which provides that the services with respect to investment commission compensation are deemed to be performed over the 12 months immediately preceding the date as of which the overall value of the assets or asset accounts is determined for purposes of calculating the investment commission compensation.

Renewal commissions may be eligible for one or more of these special rules and an insurance agent may be able to make a deferral election in the calendar year prior to the calendar year in which the insured pays the premiums to the insurance company with respect to which the renewal premiums are paid. In addition, even if the insured does not make any premium payments (e.g., the underlying policy is completely paid up), it appears that such renewal commissions may be eligible for the special rule included in the final regulations with respect to transactions consummated in a taxable year. AALU understands from informal discussions with a senior representative of the Treasury that the modification was made to address situations in which a transaction was completed (i.e., renewal of a policy) in a particular taxable year, but the customer does not make any payments during such taxable year. The representative indicated that renewal commissions should fit within this special rule. The representative also indicated that the special rule for investment commission could apply to renewal commission depending on how the renewal commissions are structured and whether such arrangement falls within the definition of investment commissions under the final regulations.

(7) Time and Form of Payment

(a) General:

In general, Code section 409A requires that payments of the deferred compensation be made at a fixed date or under a fixed schedule, or upon any of five events: (i) a separation from service, (ii) death, (iii) disability, (iv) change in the ownership or effective control of a corporation, or (v) unforeseeable emergency.

(b) When Actual Payments Must Generally Be Made:

The final regulations, like the proposed regulations, provide relatively flexible rules regarding when payments must actually be made in order to comply with the payment rules. To begin with, the final regulations provide that where the time of payment is based upon the occurrence of a specified event (as opposed to a fixed date or under a fixed schedule), the plan must designate an objectively determinable date or year following the event upon which the payment is to be made (e.g., 30 days following separation from service, or the first calendar year following the service provider's death). In addition, a payment will be treated as made upon the designated date if the payment is made by the later of: (i) the first date it is administratively feasible to make such payment on or after the designated date, or (ii) the end of the calendar year containing the designated date (or the end of the calendar year if only a year is designated). However, for purposes of applying this rule, any inability to make the payment that is caused by an action or inaction of the service provider, or any related or controlled person, will not cause the payment to be treated as administratively infeasible to make.

The final regulations include a new rule which provides that a payment will be deemed to be made at the scheduled time of payment if made no earlier than 30 days before the scheduled date, provided the service provider is not permitted, directly or indirectly, to designate the taxable year of payment.

(c) Specified Time or Fixed Schedule of Payments:

(i) General Rules:

A plan will be deemed to provide for a specified time or fixed schedule of payments where the specific date upon which payment or payments will be made may be objectively determined. For this purpose, plans can simply specify the calendar year or years in which the payments are scheduled to be made, without specifying the particular date within such year on which the payment will be made. In addition, payments can be determined based upon the date a service provider vests in the amount of deferred compensation, where the vesting is based upon the occurrence of an event (e.g., a participant designates that payment will be made in three installments, payable each December 31 following an initial public offering).

(ii) Reimbursement or In-Kind Benefit Plans: As discussed above, certain reimbursement plans that qualify as separation pay arrangements are excepted from 409A if certain requirements are satisfied. All other reimbursement or in-kind benefit plans are generally subject to 409A unless another exception applies (e.g., the short-term deferral exception). The final regulations include a special rule that will allow reimbursement and in-kind benefit plans that are subject to 409A to meet the fixed time and form of payment requirements. This special rule applies if all of the following requirements are satisfied: (A) the plan provides an objectively determinable nondiscretionary definition of the expenses eligible for reimbursement or of the in-kind benefits to be provided; (B) the plan

provides for the reimbursement of expenses incurred or for the provision of the in-kind benefits during an objectively and specifically prescribed period (including the lifetime of the service provider); (C) the plan provides that the amount of expenses eligible for reimbursement, or in-kind benefits provided, during a service provider's taxable year may not affect the expenses eligible for reimbursement, or in-kind benefits to be provided, in any other taxable year (other than certain annual or lifetime caps that may apply to medical expenses); (D) the reimbursement of an eligible expense is made on or before the last day of the service providers taxable year following the taxable year in which the expense was incurred; and (E) the right to reimbursement or in-kind benefits is not subject to liquidation or exchange for another benefit.

(iii) Tax Gross-Up Payments: The final regulations clarify that a right to a tax gross-up payment is generally subject to 409A (unless an exception applies) and provide a special rule so that such arrangements can satisfy the fixed time and form of payment requirements. These requirements will be satisfied if the arrangement provides that the tax gross up payment will be made, and the payment is made, by the end of the service provider's taxable year next following the service provider's taxable year in which the related taxes are remitted to the taxing authority.

(iv) As Soon As Administratively Feasible: The final regulations also provide limited relief with respect to plan provisions that currently provide that a payment will be made "as soon as administratively feasible" following a permissible distribution event or time. Those types of provisions did not comply with the rules prescribed in the proposed regulations. In contrast, the final regulations provide that those types of provisions will qualify as a specified payment date if the period during which such payments may be made is restricted either to a specified taxable year of the service provider or a period of not more than 90 days and the service provider is not provided an election as to the taxable year the payment will be made. For example, a plan provision which provides that a payment will be made as soon as administratively feasible after a separation from service, but in no event later than 90 days after the separation, should qualify as a specified payment date under the final regulations.

(v) Payment Schedules With Fixed or Formula Payment Limitations: If certain requirements are satisfied, the final regulations provide that payment schedules with fixed or objective formula limitations on the amount that may be paid during any particular period (e.g., no more than 10% of net cash flow in any one year) would meet the fixed time and form of payment requirements.

(vi) Payment Schedules Based on Payments to the Service Provider: Similarly, the final regulations provide that if certain requirements are satisfied, a schedule based upon the timing of payments to the service recipient would meet the fixed time and form of payment requirements. However, this special rule is intended to be available only on a limited basis. For example, one of the requirements is that the payments must be from bona fide and routine transactions in the ordinary course of business of the service recipient, and the service provider cannot have control over the service recipient, the initial payor or the collection of the payments.

(d) Separation from Service:

(i) Employees:

The final regulations retain the general rules in the proposed regulations for determining whether an employee has experienced a separation from service. Under the general rules, an employee experiences a separation from service if the employee dies, retires, or otherwise has a termination of

employment with the employer.

However, the final regulations change the standard for determining whether a termination of employment has occurred. Under the new standard, whether an employee has terminated employment is based on whether the facts and circumstances indicate that the service recipient and employee reasonably anticipated either that no further services would be performed after a certain date or that the level of bona fide services the employee would perform after such date (whether as an employee or as an independent contractor) would permanently decrease to no more than 20 percent of the average level of bona fide services performed over the immediately preceding 36-month period (or full period if less than 36 months).

The final regulations also include several rebuttable presumptions - (A) an employee will be presumed to have separated from service where the level of services drops to a level of 20 percent or less of the average services over the previous 36 months; (B) an employee will be presumed not to have separated from service where the level of services continues at a level of 50 percent or more of the average services; and (C) there is no presumption if the level of services drops to between 20 percent and 50 of the average services. The final regulations also allow a plan to define a separation from service as including a change to a reduced level of services, if the definition is specified no later than the time and form of payment are elected or otherwise specified, and the specified reduced level is greater than 20 percent but less than 50 of the average prior services.

Like the proposed regulations, the final regulations provide that the employment relationship is treated as continuing while the individual is on sick leave, or other bona fide leave of absence, if the period of such leave does not exceed six months, or if longer, so long as the individual retains a right to reemployment with the service recipient under an applicable statute or by contract. In this regard, the final regulations also clarify that a bona fide leave of absence refers to a leave of absence where there is a reasonable expectation the service provider will return to service with the service recipient.

The final regulations also include new guidance for determining separations from service in connection with mergers and acquisitions. The final regulations allow the seller and buyer in an asset sale to specify whether the "same desk" rule applies for purposes of determining whether a separation from service has occurred as a result of the transaction, provided certain requirements are satisfied, including that all similarly-situated service providers are treated consistently and that the treatment is specified no later than the closing date of the asset purchase transaction. The preamble to the final regulations also clarifies that a corporate spin-off is generally not treated as a separation from service for the service providers who continue with the spun-off company.

The final regulations also include guidance for purposes of determining when an individual who serves as both an employee and a director or independent contractor experiences a separation from service.

(ii) Independent Contractors:

The final regulations effectively retain the guidance from the proposed regulations for determining whether an independent contractor is considered to have separated from service. Under the general rule, there is a separation from service upon the expiration of the contract (or in the case of more than one contract, all contracts) if the expiration constitutes a good-faith and complete termination of the contractual relationship. The final regulations provide further that this standard is not met if the service recipient anticipates a renewal of a contractual relationship or the independent contractor becoming an employee. In addition, the final regulations include a safe harbor, under which a payment is deemed to

be on account of a separation from service. The safe harbor is met if the plan provides that: (A) no amount will be paid for at least 12 months after the contract (or contracts) expires, and (B) no amount will be paid if, after the expiration of the contract (or contracts) and before the expiration of the 12-month period in (A), the participant performs services for the service recipient as an independent contractor or an employee.

(e) Delayed Distributions for Specified Employees:

Code section 409A includes a special distribution rule for specified employees (generally "key" employees within the meaning of Code section 416(i), but determined without regard to subsection (i) (5)) of publicly-traded companies, which provides that a distribution on account of a separation from service must be delayed for at least 6 months following the separation from service. The final regulations, like the proposed regulations, include guidance regarding the application of this special distribution rule.

To begin with, the final regulations clarify that in order to satisfy this requirement, the plan terms must provide that a specified employee does not have a right to a payment before the end of the 6-month period. Merely delaying the payment is not sufficient. The final regulations also contain default rules that apply if a plan document does not specify that any permissible alternatives apply. The final regulations also clarify that the alternatives can be used only if all plans of a service recipient use the same rules (i.e., a consistency requirement).

Like the proposed regulations, the final regulations provide that the identification of specified employees is generally based upon the 12-month period ending on the identification date chosen by the service recipient. Individuals who meet the requirements during that 12-month identification period are considered specified employees for the 12-month period commencing on the first day of the 4th month following the end of the 12-month identification period. This delay in the specified employee determination is intended to give service recipients time to gather the information and make a determination before payments are actually required to be made. If a service provider does not designate an identification date and period, the final regulations provide that the identification date is December 31 and the specified employee effective date is the immediately following April 1.

The final regulations also allow service recipients to use alternative methods for identifying specified employees. The final regulations clarify that a plan may provide that all payments upon separation from service will commence six months after the separation from service, regardless of whether the service provider is a specified employee. In addition, other alternative methods may be used if certain requirements are satisfied, including that the method is reasonably designed to include all specified employees, the method is objectively determinable and the method results in no more than 200 service providers being identified as specified employees as of any date. The final regulations caution, however, that if an alternative method fails to identify any individual who is a specified employee and the individual has a right to a payment within the six-month period, the plan providing such right will not be in compliance with 409A.

The final regulations also significantly modify the proposed rules addressing the identification of specified employees following a corporate transaction, such as a merger or spin-off. For example, where two publicly-traded corporations are merged, the final regulations allow the corporations to either simply combine the two lists developed before the transaction or combine the lists and limit the specified employees to the 50 most highly compensated individuals on the combined list. The final regulations also address spin-offs, initial public offerings and mergers involving public and non-public corporations.

The final regulations provide that a service recipient may satisfy the 6-month delay requirement by (i) delaying any payments due within the 6-month period until the end of the 6 month period, (ii) delaying each scheduled payment that becomes payable pursuant to a separation from service for six months, or (iii) a combination of the methods described in (i) and (ii). In a change from the proposed regulations, the final regulations provide that a plan may not provide a participant an election as to the manner in which the 6-month delay will be implemented.

(f) Death or Disability:

The final regulations, like the proposed regulations, incorporate the definition of disability provided in Code section 409A(a)(2)(C) and provide that: (i) a plan need not provide for a payment upon all disabilities identified under Code section 409A, and (ii) a service recipient may rely upon a determination of the Social Security Administration with respect to the existence of a disability.

The final regulations clarify that elections with respect to the time and form of payment to a beneficiary are subject to the general rules governing subsequent deferral and accelerated payments, including elections by either the service provider or the beneficiary (with an exception for amounts payable under a domestic relations order, as discussed further below).

(g) Change in Ownership or Effective Control of a Corporation:

The final regulations generally retain the guidance provided in the proposed regulations regarding the change in control provisions. The preamble to the final regulations indicates that the Treasury and IRS intend to issue regulations that will allow a distribution upon a Change in Control Event involving a partnership, and, until further guidance is issued, the existing guidance with respect to corporations can be followed by analogy with respect to partnerships. The final regulations provide guidance regarding certain earn-out provisions, which are described to include an arrangement where an acquirer contracts to make an immediate payment at the closing of a transaction with additional amounts payable at a later date, subject to the satisfaction of specified conditions. The final regulations provide further that the later payments could create delays in payments of compensation calculated by reference to the value of the target corporation shares. In this situation, the final regulations provide a special rule under which the compensation payable can be treated as paid at a specified time or pursuant to a fixed schedule if: (i) the compensation is paid on the same schedule and under the same terms and conditions as payments to shareholders generally pursuant to a Change in Control Event, and (ii) the compensation is paid not later than five years after the Change in Control Event.

(h) Unforeseeable Emergency:

The final regulations, like the proposed regulations, generally incorporate the provisions from Code section 409A(a)(2)(B)(ii), which defines an unforeseeable emergency.

(i) Multiple Payment Events:

Like the proposed regulations, the final regulations provide that payments may be made upon the earlier of, or the later of, two or more specified permissible payment events or times (e.g., the earlier of age 65 or separation from service). In addition, the final regulations provide that different forms may be elected for each potential payment event (e.g., installments upon separation from service or, if earlier, a lump sum payment upon death).

(j) Delay in Payment by Service Recipient:

The final regulations provide that a plan may delay payments beyond their otherwise required payment date in the following circumstances without violating Code section 409A: (i) the service recipient reasonably anticipates that the service recipient's deduction with respect to such payment would be limited or eliminated by application of Code section 162(m) (i.e., the \$1 million cap on compensation), (ii) the service recipient reasonably anticipates that the making of the payment will jeopardize the ability of the service recipient to continue as a going concern, and (iii) the service recipient reasonably anticipates that the making of the payment will violate Federal securities laws or other applicable law.

(k) Disputed Payments and Refusals to Pay:

The final regulations provide that a payment can be delayed in certain cases if the payment is not made on the date scheduled because the obligation to make the payment or the amount of the payment is in dispute, or the service recipient simply refuses to pay. To fall within this special rule, the service provider must act in good faith and must make reasonable, good faith efforts to collect the amount. In addition, the payment must be made by the end of the calendar year (or, if later, the 15th day of the third month following the date) in which: (i) the service recipient and the service provider enter into a legally binding settlement of such dispute, (ii) the service recipient concedes that the full amount is payable, or (iii) the service recipient is required to make such payment pursuant to a final and nonappealable judgment or other binding decision.

(8) Anti-Acceleration of Payments

(a) General:

Except as expressly permitted by the Treasury and IRS, a plan may not permit the acceleration of the time or schedule of any payment. The final regulations retain all of the permissible accelerations provided in the proposed regulations and provide a number of additional permissible accelerations. Several of the permitted accelerations are summarized below.

(b) Payments Upon Income Inclusion Under Code Section 409A:

The final regulations provide that a plan may permit the acceleration of a payment to pay the amount the service provider includes in income as a result of the plan failing to meet the requirements of Code section 409A.

(c) Payments Following Plan Termination:

Under the general rule, payments cannot be accelerated upon termination of a plan. However, the final regulations permit such accelerations in three circumstances, which were only modified slightly from the proposed regulations:

(i) a plan may be terminated provided that all arrangements of the same type (e.g., elective account balance plans, nonaccount balance plans, separation pay plans or other arrangements) are terminated with respect to all participants, no payments other than those otherwise payable under the terms of the plan absent a termination of the plan are made within 12 months of the termination of the arrangement, all payments are made within 24 months of the termination of the arrangement, and the service recipient does not adopt a new arrangement of the same type at any time

for a period of three years (the proposed regulations required five years) following the date of termination of the arrangement;

(ii) a plan may be terminated during the 12 months following a Change in Control Event; and

(iii) a plan may be terminated upon a corporate dissolution under Code section 331, or with the approval of a bankruptcy court pursuant to 11 U.S.C. section 503(b)(1)(A), provided that the amounts deferred under the plan are included in the participants' gross incomes by the latest of: (A) the calendar year in which the plan termination occurs, (B) the calendar year in which the amount is no longer subject to a substantial risk of forfeiture, or (C) the first calendar year in which the payment is administratively practicable.

(d) Terminations of Deferral Elections Following an Unforeseeable Emergency or a Hardship Distribution:

The final regulations provide that a plan may provide that a deferral election terminates if a service provider obtains a payment on account of an unforeseeable emergency, or if such termination is necessary for a service provider to obtain a hardship distribution under a qualified 401(k) plan; provided that the deferral election is terminated and not merely suspended. A deferral election made after a termination of a deferral election under these special rules must be treated as an initial deferral election and must comply with the applicable rules.

(e) Distributions to Avoid a Nonallocation Year Under Code Section 409(p):

Under certain conditions, in the case of an S corporation sponsoring an employee stock ownership plan (ESOP), it may be necessary for amounts to be distributed from a nonqualified deferred compensation plan in order to avoid a nonallocation year within the meaning of Code section 409(p)(3) (which, if not corrected, could result in significant, adverse tax consequences to certain participants in the ESOP). The final regulations essentially retain the rules provided in the proposed regulations under which such distributions can be made to avoid a nonallocation year.

(f) Domestic Relations Orders:

The final regulations include a new provision which allows plans to accelerate a payment to an individual other than the service provider to the extent necessary to comply with a domestic relations order as defined in Code section 414(p)(1)(B).

(g) Distributions On Account of Death, Disability or Unforeseeable Emergency:

The final regulations also provide that the addition of death, disability or unforeseeable emergency as a potentially earlier (but not later) payment event is a permissible acceleration.

(9) Subsequent Changes in the Time and Form of Payment

(a) General:

Under Code section 409A, the time and form of distribution generally must be designated at the time of the initial deferral election. However, the statute allows for changes that further delay or change the form of payment if all of the following requirements are satisfied: (i) the change does not take effect

until at least 12 months after *the date on which the change is made*, (ii) in the case of payments made on account of separation from service, a specified time (or pursuant to a fixed schedule), or following a change in control, the first payment with respect to which the change is made must be deferred for at least 5 years from *the date the payment would otherwise have been made*, and (iii) in the case of any change related to a payment made on account of a specified time (or pursuant to a fixed schedule), the change cannot be made less than 12 months before *the date of the first scheduled payment*. These permitted change rules are collectively referred to hereinafter as the "subsequent deferral rules."

(b) Definition of Payment:

The final regulations, like the proposed regulations, provide significant flexibility with respect to the definition of payment for purposes of the subsequent deferral rules. To begin with, the final regulations provide generally that each separately identified amount to which a service provider is entitled to under a plan on a determinable date is a separate payment for purposes of the subsequent deferral rules. For example, if an arrangement provides that 50% of the benefit will be paid as a lump sum at separation from service, and the remainder of the benefit will be paid as a lump sum at age 60, the arrangement provides for two separately identified amounts.

In addition, the final regulations provide that, in general, the periodic payments under either an installment or annuity form of payment are treated as a single payment for purposes of the subsequent deferral rules (e.g., if an arrangement provides for 10 annual installments commencing at age 65, the arrangement provides for a single identified amount paid at age 65 (as opposed to each annual installment being treated as a separate payment). However, the final regulations also allow plans to designate installment payments, but not annuity payments, as a series of separately identified amounts (e.g., in the preceding example, each of the 10 annual installments could be treated as a separate payment for purposes of the subsequent deferral rules).

(c) Application to Multiple Payment Events:

As discussed above, plans may allow for payments to be made on the earlier of, or the later of, multiple specified permissible payment events, and also allow for different forms of payment depending on the payment event. For example, an arrangement provides for an annuity at age 65 or, if earlier, a lump sum payment upon separation from service. For purposes of applying the subsequent deferral rules, the proposed regulations provide that the rules are applied to each payment event separately. For example, under the preceding example, the subsequent deferral rules would apply separately to the entitlement to the installment payment at age 65, and the entitlement to the lump sum payment at separation from service.

The final regulations also provide that a plan may provide that an intervening event that is a permissible payment event under Code section 409A may override an existing payment schedule already in payment status. For example, a plan could provide for 6 installment payments commencing at separation from service, but also provide that if the participant died after the payments commenced, all remaining benefits would be paid in a lump sum.

(d) Actuarially-Equivalent Annuities

The final regulations clarify the circumstances under which two actuarially-equivalent life annuities may be treated as one form of payment and thereby allow elections among such annuity forms at any time before the initial annuity payment without regard to the subsequent deferral rules. Specifically, the final regulations provide that certain features are ignored for purposes of determining

whether an annuity is a life annuity, including (1) term certain features, (2) pop-up provisions, (3) cash refund features, (4) Social Security or Railroad Retirement leveling features, and (5) features applying a permissible cost-of-living index. The final regulations also provide that a subsidized joint and survivor annuity is treated as actuarially equivalent to a single life annuity provided that none of the annual benefits payable under the joint and survivor annuity are greater than the annual lifetime annuity benefits available under the single life annuity.

(10) Material Modifications to Grandfathered Plans

A grandfather plan (i.e., a plan that includes only amounts deferred before January 1, 2005) is not subject to Code section 409A unless it is materially modified on or after October 3, 2004. The proposed regulations provided guidance about what modifications constitute material modifications for purposes of grandfathered plans. The final regulations generally follow the proposed regulations with respect to material modifications and include a number of new rules and other clarifications.

(11) Transition Rules

(a) General:

IRS Notice 2005-1 and the preamble to the proposed regulations included a number of transition rules which generally applied through the end of 2006. Several of those transition rules were extended through the end of 2007 by IRS Notice 2006-79, subject to certain conditions and modifications. The final regulations do not extend any of the transition rules beyond 2007. However, the preamble to the final regulations does provide additional guidance with respect to the transition period. The transition rules that are applicable through the end of 2007 and the additional transition guidance provided in the preamble to the final regulations are summarized below.

(b) Amendment and Operation of a Plan:

Notice 2006-79 extended until December 31, 2007 the deadline by which plan documents must be amended to conform with Code section 409A. The final regulations do **not** extend that deadline any further. Until such time, a plan generally must be operated in good faith compliance with Code section 409A and the applicable transition guidance.

(c) Changes in Time and Form of Payment:

Notice 2006-79 extended the transition rule for making new payment elections or amendments through the end of 2007. The final regulations do **not** extend this deadline any further. Under this transition rule, with respect to new payment elections or amendments made in 2007, the election or amendment may apply only to amounts that would not otherwise be payable in 2007 and may not cause an amount to be paid in 2007 that would not otherwise be payable in 2007 (i.e., cannot accelerate a payment into 2007 or defer a payment out of 2007). Notice 2006-79 also provided that a deferral election may be made with respect to an amount that is a short-term deferral, provided that the election is made before January 1, 2008 and before the year in which the amount would otherwise have been paid. For example, if a 2007 calendar year bonus is required to be paid within 2-1/2 months following the close of 2007, a deferral election with respect to such bonus could be made by the end of 2007 under this special transition rule.

(d) Payments Based on Elections Under Qualified Plans:

Payment elections under a nonqualified deferred compensation plan that mirror or depend upon a payment election under a qualified plan generally do not satisfy the payment election rules under Code section 409A because such elections generally are not made at the time the deferral election is made. Notice 2006-79 extended a special transition rule through the end of 2007 that allows such payment elections to continue in effect through the end of 2007. The final regulations do **not** extend this deadline any further. Thus, nonqualified plans under which payment elections are tied to a payment election under a qualified plan will have to be modified by January 1, 2008 to comply with the 409A payment election rules.

(e) Substitution of Non-Discounted Stock Rights for Discounted Stock Rights:

Notice 2006-79 extended a special transition rule through the end of 2007 that allows discounted stock rights that do not comply with Code section 409A to be replaced with non-discounted stock rights that are excepted from the new rules; provided certain requirements are satisfied (e.g., the transition rule does not apply if the stock right is exercised before the replacement). The final regulations do **not** extend this special transition rule any further. The extension through the end of 2007 did not apply to insiders of publicly-traded companies that were expected to restate their financial statements to reflect the discounted options (e.g., in connection with the back-dating controversy). The insiders generally had to replace any discounted options by the end of 2006.

(f) Additional Transition Guidance Provided in the Preamble to Final Regulations:

The preamble to the final regulations provides the following additional transition guidance:

(i) Stock Rights: The preamble to the final regulations confirms that stock rights issued before the effective date of the final regulations (i.e., January 1, 2008) must generally comply with 409A or otherwise qualify for an exception (i.e., no categorical exception for such stock rights). However, the preamble also prescribes some special transition rules for stock rights issued before certain dates.

First, with respect to stock rights issued before January 1, 2008, the exercise price will not have to be adjusted to reflect a fair market value exercise price in accordance with the final regulations if the exercise price was at least equal to fair market value as of the date of grant under the applicable transition guidance, which primarily includes Notice 2006-4. Under that notice, the IRS indicated that with respect to stock rights issued before January 1, 2005, the valuation standards that apply to ISOs generally apply, which generally means that where the sole reason the stock right would fail to qualify for the exclusion from 409A is due to the exercise price not being set at or above fair market value, the exercise price will be treated as set at or above fair market value if based upon a good faith attempt by the issuer to set the exercise price at or above fair market value. In addition, with respect to stock rights issued on or after January 1, 2005 and before January 1, 2008, the valuation guidance provided under Notice 2005-1 applies, which generally requires the fair market value to be determined using a reasonable valuation method. The preamble to the final regulations also clarifies that plan sponsors may rely on the valuation guidance provided under either the proposed or final regulations for any stock rights issued before January 1, 2008.

Second, the preamble to the final regulations provides a special transition rule for stock rights that were issued before April 10, 2007 (i.e., the date the final regulations were issued), on stock that would have constituted service recipient stock under a reasonable good faith interpretation of the statute and applicable guidance, but would not constitute service recipient stock under the final regulations. Under this special transition rule, such stock will continue to constitute service recipient stock until the

right is either exercised, terminated or modified in a manner that is treated as the grant of a new right. However, the preamble clarifies that with respect to stock rights issued on or after April 10, 2007, the stock subject to the right will not be treated as service recipient stock after December 31, 2007, unless the stock satisfies the requirements of the final regulations.

Third, the preamble provides additional guidance regarding modifications and extensions of stock rights that occur before January 1, 2008. The preamble provides that any modifications or extensions that occurred before the enactment of the statute (October 23, 2004) will not be considered in determining whether the right is excluded from coverage under 409A. In addition, the final regulations themselves provide that any extension granted before April 10, 2007, solely in order to provide an additional period of time within which to exercise the stock right beyond the time originally prescribed, is disregarded for purposes of the rules treating certain extensions as deferral features from the time of grant.

(ii) Initial Deferral Elections: The preamble provides guidance regarding the impact of the final regulations on initial deferral elections made before January 1, 2008. In general, if a deferral election made before such date was consistent with the proposed regulations or the applicable transition guidance, the initial deferral election will be deemed to comply with 409A, regardless of whether the period of deferral extends beyond 2007. The preamble also addresses arrangements established before January 1, 2008, where initial deferral elections have not been made by such date. For example, an arrangement that the plan sponsor determines as providing performance-based compensation under a reasonable good faith interpretation, but does not qualify as such under the final regulations. With respect to such arrangements, for arrangements established before April 10, 2007 (the date the final regulations were issued) that would have permitted an initial deferral election to be made in 2008, an initial deferral election will be deemed to comply with the initial deferral election rules if made by the deadline established under the arrangement. With respect to such arrangements that would have permitted an initial deferral election to be made after December 31, 2008, an initial deferral election will be deemed to comply with the initial deferral election rules if made by December 31, 2008.

(iii) Designation of Time and Form of Payment: The preamble confirms that a payment scheme that violates the provisions of the final regulations will need to be brought into compliance with the final regulations in accordance with the transition relief, which generally permits service providers and service recipients to change the time and form of payment at any time through the end of 2007. For example, as discussed above, arrangements under which payments are made in accordance with distribution elections under a qualified retirement plan will have to be modified by the end of 2007 to include payment elections that fully comply with 409A. The special transition rule that allows such plans to continue operationally during the transition period will expire at the end of 2007.

(iv) Service Providers in Pay Status: The preamble addresses service providers that are already in pay status, where the payment trigger is based upon a reasonable, good faith interpretation of the statute and applicable guidance but is not in compliance with the final regulations. In this situation, where payments have commenced before January 1, 2008, the plan may continue to make such payments consistent with the plan terms at the time the payments commenced, or may halt such payments on or before December 31, 2007, and amend the time and form of any remaining payments to comply with the final regulations in accordance with the transition guidance provided. Similarly, where payments have not commenced, but all the events necessary to receive the payment have occurred, the plan may make payments in accordance with the terms of the plan or may amend the time and form of payments to comply with 409A in accordance with the transition guidance. The preamble also addresses a situation in which payments did not commence under a reasonable, good faith interpretation that a separation from service did not occur, but under the final regulations payments

should have commenced. In this situation, the plan must treat the service provider as having separated from service on a date on or after April 10, 2007, and on or before December 31, 2007.

The preamble also addresses the application of the six-month delay requirement for specified employees of public corporations where separation from service occurs on or before December 31, 2007, under circumstances that under a reasonable, good faith interpretation would not result in application of the six-month delay requirement. In this situation, the preamble provides that the beginning or continuation of payments of deferred compensation on or after January 1, 2008 will not result in a violation of the six-month delay requirement.

(v) Collectively Bargained Plans: Nonqualified plans that are maintained pursuant to one or more collective bargaining agreements in effect on October 3, 2004 are not required to comply with 409A until the earlier of: (1) the date the last such collective bargaining agreement terminates (determined without regard to any extension of any agreement after October 3, 2004), or (2) December 31, 2009. The preamble clarifies that such plans may make new payment elections under the general transition rules until the day immediately preceding the day the plans are first subject to 409A. The same treatment also applies to the special transition rule that allows service providers to elect to defer short-term deferrals, provided that the election is made before 409A becomes applicable and before January 1 of the calendar year in which the amount would otherwise have been paid.

(12) Matters Not Covered by the Final Regulations

As expected, the final regulations do not address the calculation and timing of amounts required to be included in income under section 409A or provide any further guidance regarding the reporting and withholding requirements imposed by the section. The preamble to the final regulations indicates that the IRS and Treasury intend to issue further guidance with respect to these issues, including additional transition guidance "as may be appropriate" with respect to the reporting and withholding requirements.

(13) What Plan Sponsors Should be Doing

With the issuance of the final regulations, plan sponsors now have all of the guidance necessary to amend their plans to comply with the substantive requirements of 409A. All plans must be compliant both in form and operation by December 31, 2007. Thus, plan sponsors should be reviewing all of their arrangements to determine which ones are subject to 409A, and if so, identifying what changes, if any, are required to bring the plans into full compliance. Plan sponsors must then amend their plans as necessary to fully comply before the end of 2007.

Any AALU member who wishes to obtain a copy of the final 409A regulations or IRS Notice 2007-34 may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at <http://www.aalu.org/> and enter the *Member Portal* with your social security number and select *Current Washington Report* for linkage to source material or (3) email Angela Street at street@aalu.org and include a reference to this *Washington Report*.

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