Where published
THE TAX EXECUTIVE

May-June 2007

Getting Up to Speed on the Final Regulations for Deferred Compensation

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Section 409A of the Internal Revenue Code of 1986 requires that nonqualified deferred compensation plans meet specific requirements relating to the timing of deferral elections, the time and manner in which distributions may be made, and the circumstances under which amounts previously deferred may be either further deferred or accelerated. If these requirements are not met, the amount deferred is generally included in the income of an employee in the year in which the employee became vested in the right to receive the compensation, a 20-percent additional tax is imposed on that income, and an interest charge may also be imposed.

In April 2007, the Internal Revenue Service issued final regulations under section 409A that address many (but by no means all) of the questions that have arisen regarding the application of the complex provisions of the statutory provision to deferred compensation plans. The final regulations are effective on January 1, 2008, and, thus, all deferred compensation plans subject to section 409A must be in full compliance by the end of this year. This article provides an overview of key topics covered by the final regulations, with a particular focus on issues that were not addressed, or that were addressed differently in the notices and proposed regulations that preceded the final regulations.

Nonqualified Deferred Compensation Plan

A nonqualified deferred compensation plan under section 409A means any plan that provides for a deferral of compensation. Thus, section 409A deferred compensation plans are not limited to arrangements between employers and employees.[1] Section 409A also applies to arrangements between a corporation and one or more of its outside directors or independent contractors.

The final regulations provide that whether a plan provides for deferral of compensation is generally determined at the time the employee obtains a legally binding right to compensation under the plan. The determination that a plan constitutes a deferred compensation plan is not affected by a retroactive change to the plan to characterize the employee's right as one that does not provide for the deferral of compensation.

The final regulations provide that the following plans are not subject to section 409A:

- Qualified employer plans, such as 401(k) plans, pension plans, and tax deferred annuities.
- Certain welfare benefit plans, such as bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans.
- Medical reimbursement arrangements that provide benefits that are excludable from gross income.
- Certain foreign retirement plans that provide benefits to a broad-based group of employees.
- Contributions made on behalf of employees (and earnings thereon) that are excludable from income under an income tax treaty.

Deferral of Compensation

A. In General

Under the final regulations, a plan generally provides for the deferral of compensation if the employee has a "legally binding right" during one taxable year to compensation that is (or may be) payable to the employee in a later taxable year. For this purpose, a plan will be treated as providing for a payment to be made in a subsequent year whether the plan explicitly so provides (including through a deferral election by the employee) or the deferral condition is inherent in the agreement. For example, if the parties agree that payment will be made upon an event that "could" occur after the year in which the legally binding right to the payment arises, the agreement will generally be considered to provide for a deferral of compensation (unless such arrangement is excluded from section 409A under a specific exception, such as the short-term deferral rule described below).

A deferral of compensation is generally defined under the final regulations in the context of a legally binding right to a payment of compensation in a future taxable year. For purpose of the regulations, a legally binding right includes a contractual right that is enforceable under the law governing the contract. Although an employee is not considered to have a legally binding right to compensation that can be reduced or eliminated by the employer after the services giving rise to the compensation have been performed, the final regulations make it clear that a legally binding right can exist even if the right can be reduced or eliminated by application of a nondiscretionary, objective provision creating a substantial risk of forfeiture.

B. Short-Term Deferrals

The "short-term" deferral rule provided under the final regulations is a very useful and important exception to the expansive rules defining a deferral of compensation. Under this rule, a deferral of compensation does not occur if:

- the arrangement under which the compensation is paid does not provide for a deferred payment of compensation, and
- the compensation payment is includible in income no later than 2½ months after the end of the first year in which the legally binding right to the payment arises or, if later, the first year in which the compensation is no longer subject to a substantial risk of forfeiture (the "2½ month period").

1. Operation of Short-Term Deferral Rule

There are several important rules provided in the final regulations illustrating the operation of the short-term deferral rule, as follows:

- The right of an employee to make a deferral election with respect to compensation will not preclude the application of the short-term deferral rule to such compensation provided that the employee does not make the deferral election and payment is actually made within the 2½ month period.
- If a plan provides for payment on or after an event or date that will or "may" occur after the end of the 2½ month period, the plan will be considered to provide for a deferral of compensation, regardless of whether the amount is actually paid as a result of the occurrence of such payment event or date during the 2½ month period.
  - For example, assume an employer awards a bonus to its employee on November 1, 2008, and the employee has a legally binding to such payment as of such date. Under the bonus plan (i) the employee will forfeit the bonus unless the employee continues performing services through December 31, 2010 (thus, the employee's right to such bonus is subject to a substantial risk of forfeiture until December 31, 2010) and (ii) the bonus is scheduled to be paid as a lump sum on July 1, 2011. Because the specified payment date is after the 2½ month period (March 15, 2011, in this example) the bonus plan will be considered to provide for a deferral of compensation and will not qualify for the short-term deferral rule regardless of whether the bonus is paid on or before March 15, 2011.[2]
  - Further, based on the facts of the above example, assume (i) the legally binding right to the bonus that the employee acquires on November 1, 2008, is *not* subject to a substantial risk of forfeiture, and (ii) instead of a scheduled payment date of July 1, 2011, the bonus is scheduled to be paid as a lump sum upon the employee's separation from service. Under these facts, because separation from service is an event that may occur after the 2½ month period (March 15, 2009, in this example), the bonus plan will be considered to provide for a deferral of compensation and not qualify for the short-term deferral rule. This is so even if the employee separates from service and the bonus is paid on or before March 15, 2009.[3]
- If a plan does not specify a payment date or payment event, payments made within the 2½ month period will qualify for the short-term deferral rule. If in this case payment is made outside of the 2½ month period, however, section 409A will generally be violated because of the failure to pay upon a specified date or event.
- If the plan specifies a payment date within the 2½ month period and payment is not made within such period but is made within the same year in which the payment date occurs, such payment, though now subject to section 409A, will generally comply with section 409A. Often, bonus plans or similar arrangements do not provide for a specified payment date. Thus, it is important that those arrangements that are intended to fall within the short-term deferral rule specify a March 15 payment date (or any earlier date within the 2½ month period) to prevent inadvertent violations of section 409A.

2. Certain Delayed Payments

Under the final regulations, payments that otherwise qualify for the short-term deferral rule that are made outside of the 2½ month period may still qualify as a short-term deferral under the following circumstances:

- The delay in payment was due to an unforeseeable administrative delay.
- The making of the payment within the 2½ month period would have jeopardized the ability of the employer to continue as a going concern.
- The delay in payment was necessary to prevent the loss of a deduction under section 162(m) (which generally disallows the deduction of compensation in excess of $1 million).

C. Stock Options and Stock Appreciation Rights

Compensatory stock options and stock appreciation rights (collectively, "stock rights") are, in general, subject to the requirements of section 409A, unless they come within a safe harbor provided under the final regulations. Stock rights will be within the safe harbor if they incorporate the following elements: (i) they must be granted on stock of the employer; (ii) the exercise price (or, with respect to stock appreciation rights, the price by reference to which any appreciation is determined) must never be less than the fair market value of the underlying shares at the time of grant; and (iii) the stock right must not include additional deferral features such as, for example, a provision for the deferral of the delivery of shares or other payment after exercise. In addition to those stock rights covered by the safe harbor, incentive stock options that are described in section 422, and stock options granted under an employee stock purchase plan described in section 423, are excluded from coverage under section 409A because they do not constitute a deferral of compensation for section 409A purposes.

The final regulations address in a helpful manner various issues regarding the section 409A safe harbor for stock rights.

1. Employer Stock

In general, the underlying stock may be any class of stock of the employer that is "common stock" within the meaning of section 305 of the Code. If, however, a class of stock has any preference for distributions other than merely a preference on liquidation, stock rights issued with respect to that class will not be within the scope of the safe harbor.

The stock must be issued by "an eligible issuer of service recipient stock." That includes not only an employer corporation, but also any corporation in a chain of ownership in which each corporation or other entity beginning with the issuer has a controlling interest — in general, 50 percent or greater ownership by vote or by value — in another entity in the chain, with the chain ending with the corporation or other entity to which the employee provided services on the date of grant of the stock right. The 50-percent minimum ownership standard is reduced to 20 percent where the use of stock by a controlling entity (rather than stock of the service recipient itself) was based on "legitimate business criteria." In general, such legitimate business criteria are more likely to be established where the issuer is actively involved in the management of the business by which the recipient of the option is employed than where the issuer of the stock is merely a passive investor. Implicit in this definition is that stock of a subsidiary that is controlled directly or through tiers of ownership by the employer generally cannot be used for the issuance of stock rights within the scope of the safe harbor.

2. Valuation of Stock

The exercise price or reference price of the stock right must not at any time be less than the fair market value of the underlying shares on the date of the grant. Thus, an option with an exercise price per share initially equal to the fair market value of a share at the time of grant, but which further provides for the option price to be reduced by reason of subsequent dividends paid on outstanding shares, will generally not comply with the safe harbor. Where the shares are not publicly traded, the regulations provide that value must be determined "by the reasonable application of a reasonable valuation method."

A valuation determined by an independent appraisal that meets specified criteria, as of a date no more than 12 months before the date of the transaction to which the valuation is being applied, is presumptively reasonable. Certain other valuations may also be acceptable. The final regulations specifically provide that recent arm's-length transactions involving the sale or other transfer of stock are among the factors to be considered in valuing the shares.

3. Modification of Stock Options

The modification of an existing stock option in a manner that reduces the exercise price is considered to be the grant of a new option at the time of modification. If the new option is outside the terms of the safe harbor for stock rights, for example, because the exercise price is below the value of the underlying stock on the date of modification, the requirements of section 409A will apply to the modified option; and, unless the option has features specifically designed to meet those requirements, the option holder will be subject to penalties inherent in noncompliance with section 409A, including the acceleration of income to the time the option vests (or at the time of the modification, if the option is already vested) and the imposition of an additional 20-percent tax.

- **Extension of option term.** The final regulations offer some flexibility with respect to a change in the terms of an option that consists of an extension of its term. If the exercise period of an option is extended to a date that is not later than the earlier of (i) the latest date on which the option might have been exercised by its original terms or (ii) the tenth anniversary of the original date of grant, that extension will not be treated as a change in terms causing the option to fall outside the safe harbor. Thus, if an employer desires, in connection with a termination of employment, to extend the term of outstanding employee options that would otherwise lapse upon or shortly after the termination of employment, that extension should not cause the employee's options to become subject to section 409A so long as the extension does not continue beyond the original term of the option or beyond the tenth anniversary of the date of grant of the option.
- **Modification of stock right in corporate transaction.** Stock rights are often assumed by the acquiring corporation in connection with a corporate transaction, such as an acquisition of the stock of a corporation or its assets, and become exercisable with respect to the shares of the acquiror. Under the final regulations, such a modification in connection with a "corporate transaction" (generally, including a reorganization, or acquisition of a business through transfer of assets or stock) should not cause the modified right to fail to meet the safe harbor, regardless of whether the holder of the stock right becomes employed by the successor entity, so long as the terms of the modifications are consistent with the modifications that would be permissible in the corporate transaction context with respect to incentive stock options. Those rules are generally designed to assure that the employee's equity-based incentive is preserved but not enhanced by reason of the modification.

D. Restricted Stock

The grant of restricted stock or other property is not considered to be a deferral of compensation subject to section 409A merely because it is (i) excludable from income at the time of grant by reason of the shares being substantially nonvested (within the meaning of regulations under section 83), or (ii) included in income at the time of grant solely by reason of an election under section 83(b). Also, the grant to an employee of a right to elect to receive compensation for future services in the form of either restricted stock or stock options that fall within the stock rights safe harbor is generally not section 409A deferred compensation (because none of these alternatives would constitute a deferral of compensation subject to section 409A). The regulations caution, however, that the receipt of a legally binding promise to transfer property in a future taxable year, not subject to a substantial risk of forfeiture, may constitute a deferral of compensation subject to section 409A.

E. Separation Pay Plans

In general, separation pay arrangements are subject to the rules of section 409A, including the six-month delay rule (further described below) that precludes payments of deferred compensation to "specified employees" within six months after separation from service, and the rules that deferred compensation must be paid, in general, either at the time of the distribution event or at a time or on a schedule determinable at the time of the event. To permit certain types of separation arrangements, not likely to result in the types of abuses to which section 409A was directed, to be continued without the restrictions imposed by section 409A, the final regulations provide that certain types of separation arrangements will not be considered deferred compensation, for purposes of section 409A, including: (i) a collectively bargained separation pay plan that provides for separation pay only upon an involuntary separation from service or pursuant to a window program;[4] (ii) foreign separation pay plans that provide for amounts of separation pay required to be provided under the laws of a foreign jurisdiction; (iii) certain arrangements providing separation pay due to involuntary separation from service; and (iv) certain reimbursement arrangements providing for expense reimbursements or in-kind benefits following separation from service.

1. Involuntary Separation and Window Plans

A separation pay plan in which payment is triggered only by an involuntary separation from service, or the employee's voluntary participation in a window program will not be considered to provide for the deferral of compensation for purposes of section 409A if:

- payments do not exceed the lesser of (i) two times the employee's annual compensation for the taxable year preceding the year of termination, as adjusted for certain expected increases, or (ii) two times the compensation limit applicable to qualified plans under section 401(a)(17) of the Code ($225,000 for 2007); and
- payments are completed by the end of the second calendar year following the year of separation from service.

In an important clarification, the final regulations provide that where an employee is entitled to separation pay that quali-

fies for this exception except that the separation pay exceeds the applicable compensation limit, the separation pay plan will not be subject to section 409A to the full extent of all the amounts payable under the plan; rather, only the amount of separation pay in excess of the limit will be subject to section 409A.

2. Separation for "Good Reason"

The IRS struggled with the issue whether, and under what circumstances, a separation from service by the employee for good reason should be treated as an involuntary separation from service for section 409A purposes. Ultimately, the IRS included in the final regulations a safe harbor under which a separation from service will be treated as an involuntary termination if it occurs within a predetermined period of not more than two years following the initial existence of one or more of the following conditions (without the consent of the employee): (i) a material diminution in the employee's base compensation; (ii) a material diminution in the authority, duties, or responsibilities of the employee; (iii) a material diminution in the authority, duties or responsibilities of the person to whom the employee is required to report; (iv) a material diminution of the budget over which the employee retains authority; (v) a material change in the geographic location where the employee works; and (vi) any other action or inaction constituting a material breach of the agreement under which the employee works.

Also, for the safe harbor to apply, the payment upon separation from service for good reason must be substantially identical to the payment that would be made upon an involuntary separation from service; the employee must be required to provide notice to the employer of the condition on the basis of which the employee may terminate for good reason, within 90 days of the occurrence of the condition; and the employer must have at least 30 days in which to cure.

A voluntary separation from service not described in the safe harbor may nonetheless be treated as a separation for good reason under appropriate circumstances. In general, the conditions under which a separation for good reason may occur must be prespecified, and must require actions by the employer resulting in a material adverse change to the employment conditions of the employee. Other circumstances taken into account for this purpose include whether the payment upon separation for good reason is the same as the payment that would have been made upon an actual involuntary separation from service, and whether the employee is required to provide to the employer notice of the relevant condition and an opportunity to cure.

3. Reimbursements and Certain Other Payments

A separation pay plan (including a plan providing for payments upon a voluntary separation from service) will not be considered a deferral of compensation under section 409A to the extent it provides for reimbursement of certain amounts (not otherwise excludable from gross income) that would otherwise be deductible by the employee under sections 162 and 167 as business expenses incurred in connection with the production of income, or of reasonable outplacement and moving expenses, for a limited period of time — specifically, of expenses incurred on or before the last day of the second taxable year following the year of separation from service.

With respect to payments (not otherwise excludable from gross income) of reimbursements of medical expenses paid by the employee and not reimbursed by any person other than the employer, and that would otherwise be generally deductible by the employee as medical expenses, a plan providing for such reimbursements will not be considered to provide for a deferral of compensation to the extent the right to reimbursements is limited to the period that the employee is entitled (or would be entitled but for this reimbursement plan) to receive continuation coverage under a group health plan of the employer under COBRA (generally, 18 months following termination).

The provision of reimbursements of expenses incurred by an employee, such as for country club dues, not within the scope of one of the separation plan exceptions noted above, in a manner that constitutes a deferral of compensation within the meaning of section 409A, will be considered to comply with the requirements of section 409A relating to a fixed time or schedule of payments, if the plan meets the following requirements: (1) the plan includes an objective and nondiscretionary definition of the expenses eligible for reimbursement, and an objectively defined term (which could be, for example, for the employee's lifetime or for a period of years); (2) with respect to reimbursement arrangements other than certain medical reimbursement arrangements, the expenses eligible for reimbursement during an employee's taxable year may not affect the expenses eligible for reimbursement in any other taxable year; and (3) the reimbursement of an eligible expense must be made on or before the last day of the service provider's taxable year following the taxable year in which the expense was incurred.

F. Tax Equalization Agreements

A tax equalization agreement — for example, an agreement to make payments to an employee to compensate the employee for some or all of the taxes imposed by a foreign jurisdiction, in excess of the taxes that would have been imposed if the compensation were subject only to U.S. federal, state and local taxes — is not considered to provide for a deferral of compensation under section 409A if the payments are made no later than the end of the second taxable year of the employee beginning after the year in which the employee's U.S. federal income tax return is required to be filed.

G. Indemnification and Liability Insurance Plans

In general, an employee's right to payment by his or her employer of the employee's legal expenses arising from claims associated with the employee's duties is not a deferral of compensation subject to section 409A to the extent the reimbursement is for bona fide expenses incurred or damages paid by reason of a claim against the employee relating to services provided for the employer.

H. Legal Settlements

An employer's payment to an employee pursuant to a settlement or award that resolves bona fide legal claims based on wrongful termination, employment discrimination, the Fair Labor Standards Act, or workers' compensation statutes, or for the reimbursement of reasonable attorneys fees or other reasonable expenses incurred by the employee related to such bona fide legal claims, is not considered to be a deferral of compensation under section 409A, regardless of whether such payment is treated as compensation for federal tax purposes.

Plan

The final regulations broadly define the term "plan" to include any agreement, method, program or other arrangement, including any agreement, method, program or other arrangement that applies to one person or individual. A plan may constitute a plan for purposes of section 409A regardless of whether the plan is an employee benefit plan under ERISA.

A. Plan Aggregation Rules

In general, the provisions of section 409A are applied as if one or more separate plans are maintained for each employee. This is particularly significant in that all plans of a similar type maintained by the employer are aggregated and treated as one plan for certain purposes of section 409A. For example, if a section 409A violation occurs because of an improper distribution to an employee under a plan, the adverse tax consequences of section 409A would apply to all of the employee's deferred amounts under that plan and all other plans of the same type in which the employee is a participant.

The final regulations significantly liberalize the plan aggregation rules by increasing the categories of plans from four to nine. The plan categories provided by the final regulations are as follows:

- account balance plans with elective deferrals;
- nonelective account balance plans (including match and nonelective amounts);
- nonaccount balance plans (*e.g.,* SERPs);
- separation pay plans in which payment is made upon an involuntary separation from service;
- reimbursements and in-kind benefit plans;
- stock rights (stock options, stock appreciation rights, etc.);
- split-dollar life insurance arrangements;
- certain foreign plans; and
- all other deferred compensation plans.

The expansion of the categories of plans for section 409A purposes is significant in several respects. First, since a section 409A violation triggers adverse tax consequences to the affected employee with respect to all plans of the same type, the expanded categories should reduce the consequences of noncompliance. For example, if an employee is participating in both an elective deferral plan in which small amounts are being deferred and a nonelective excess account balance plan which provides benefits in excess of the qualified plan limitations, a section 409A violation in the elective deferral plan would not cause the onerous tax consequences of Section 409A to apply to the amounts deferred under the excess plan. Additionally, the expansion of the categories of plans for plan aggregation purposes should significantly increase an employee's ability to use the newly eligible deferral election rule (as discussed more fully below). Finally, the expanded plan categories should provide additional flexibility with respect to those deferred compensation plan terminations that generally require the termination of all plans of a similar type in order for the termination to be permitted under the final regulations.

B. Plan Document Requirements

The final regulations require that each deferred compensation plan subject to section 409A be in writing and include certain provisions required by the regulations. The final regulations further require that all section 409A plans be in compliance with the written document rules by the end of 2007. Although operational violations of section 409A will generally affect only the employee involved in the violation, the failure of a section 409A plan to comply with the written document rules will result in adverse tax consequences for all participants in that plan.[5]

In general, the final regulations require that a section 409A plan document specifically provide for the following:

- If a plan provides for a deferral election, the document must set forth the conditions under which the initial and subsequent deferral elections may be made.
- At the time an amount is deferred, the document must specify the amount to which the employee has a right to be paid (or the formula to determine such amount), and the time and form of payment.
- The six-month delay for payments to "key employees" of public companies must be specified in the document by the time the employee first becomes a key employee.

In response to questions regarding whether section 409A document compliance could be ensured with a "savings clause," the final regulations specifically provide that general provisions of a plan that purport to nullify noncompliant plan terms, or to supply required plan terms, are disregarded. Accordingly, if a plan contains terms that fail to meet the requirements of section 409A or fails to contain a term necessary for section 409A compliance, the plan will violate the requirements of section 409A regardless of whether the plan contains such a savings clause.

All section 409A plans must satisfy the written document rules by the end of 2007, to be effective January 1, 2008. The final regulations do not, however, require that those actions taken under the various IRS transitional rules for 2005-2007 be contained in the plan document that will be effective January 1, 2008, to the extent that such actions do not affect the plan's compliance with section 409A for periods after 2007. Although plan documentation of these actions are not required, the final regulations caution that the employer must be able to demonstrate that the plan was in all respects operated in compliance with the transition guidance, including demonstrating that amounts were deferred or paid in compliance with the transition rules.

Deferral Election Rules

A. Initial Deferral Election

The initial election to defer compensation under section 409A must generally be made and become irrevocable by the end of the year prior to the year in which the compensation is earned. An election to defer compensation includes an election with respect to the time and form of payment of the deferred compensation.

The final regulations confirm that a plan may provide that an employee's deferral election remains in effect until terminated or modified by the employee. For example, if a plan provides that an employee's election to defer 10 percent of his compensation will remain in effect until changed or revoked, but that as of each December 31 the election becomes irrevocable with respect to salary payable in connection with services to be performed in the immediately following year, that election procedure will satisfy the initial deferral election rules.

1. Newly Eligible Employees

If an employee has not previously been eligible to participate in a plan, the employee may make his initial deferral election within 30 days of the date the employee becomes eligible for the plan but only with respect to compensation to be paid for services to be performed after the election (the "newly eligible deferral election rule"). The final regulations confirm that the plan aggregation rules apply for purposes of this rule. Thus, if an employee is already participating in a plan required to be aggregated with the plan for which the employee is initially eligible, the employee would not be able to take advantage of the newly eligible deferral election rule. The liberalization of the plan aggregation rules under the final regulations, however, should enable employees to make more use of the newly eligible deferral election rule as well as reduce inadvertent violations of the

initial deferral election rules. For example, an employee who is currently participating in a nonelective account balance plan may now utilize the newly eligible deferral election rule in connection with the employee's commencement of participation in an account balance plan with elective deferrals.

The final regulations include additional guidance regarding whether an employee is newly eligible to participate in a deferred compensation plan. In general, an employee is considered to have previously been eligible to participate in a plan (and, thus, is not newly eligible) if the employee was eligible to accrue an amount of deferred compensation under the plan, regardless of whether the individual actually elected to participate in the plan.

Even if an employee has previously been eligible to participate in a plan, the final regulations provide that the employee will be treated as a newly eligible employee if the employee has received a distribution of all amounts deferred under the plan and ceased to be eligible to continue to participate in the plan by the date of the last payment. Additionally, regardless of whether a distribution of all deferred amounts has been made, any employee who ceases to be eligible to participate in the plan, *e.g.*, by reason of a transfer to a position not eligible for the plan, may again qualify as a newly eligible employee if the employee has not been eligible to participate in the plan (other than the accrual of earnings on amounts previously deferred) for at least 24 months.

The final regulations add a helpful rule regarding the application of the newly eligible deferral election rule to elections regarding the time and form of payment under nonelective excess benefit plans. A *nonelective excess benefit plan* is a deferred compensation plan (i) in which the employee is not given the opportunity to elect between current and deferred compensation and (ii) that provides deferred compensation limited to the excess of the benefit the employee would have accrued under the qualified plan, in the absence of any of the contribution or benefits limitations required to be incorporated into the qualified plan, over the benefit that the employee actually accrues under the qualified plan.

Under this special rule, an employee may be treated as newly eligible as of the first day of the year following the year in which the employee first accrues a benefit under the nonelective excess benefit plan. For example, if the employee first accrued a benefit under the nonelective excess benefit plan for 2008, under the newly eligible deferral election rule, the employee would have the first 30 days in 2009 to make an election regarding the timing and form of payment and have the election apply to the benefits accrued for services performed in 2008. The final regulations provide, however, that this special rule may be used only once with respect to an employee's participation in a nonelective excess benefit plan.

2. Ad Hoc Award

An ad hoc award is an amount that an employee has a legally binding right to receive, subject to the condition that the employee continues to be employed by the employer for a period of at least 12 months. The final regulations confirm that the initial deferral election rule will be complied with if (i) the election to defer the ad hoc award is made on or before the 30th day after the employee obtains a legally binding right to the award, and (ii) the award is conditioned on the employee remaining employed for at least 12 months from the date of the employee's deferral election. For example, assume an employee is granted on March 1, 2008, the right to receive a bonus on March 1, 2010, provided that the employee continues performing services for the employer through that date. The employee may make an initial election on or before March 31, 2008, to defer to a later date the payment of the award.[6]

3. Performance-Based Compensation

Generally, the initial election to defer performance-based compensation may be made up to six months prior to the end of the period used to determine the amount (if any) of the performance-based compensation.[7] For example, an election to defer a performance-based bonus for calendar year 2008 could generally be made as late as June 30, 2008. The final regulations clarify that the election to defer performance-based compensation must be made before the amount of the performance-based compensation is "readily ascertainable."

For this purpose, if a right to a specified amount of compensation is subject to a performance requirement being met (*e.g.*, a right to payment of a $20,000 bonus if a certain profit level is attained), the compensation amount is treated as readily ascertainable when it is substantially certain that the performance requirement will be satisfied. If the right to the amount of compensation depends on the level of performance, the compensation (or any portion of the compensation) is treated as readily ascertainable when it is both possible to calculate the amount of the compensation payment and substantially certain that the performance requirement will be met. In this situation, the final regulations provide that if only a portion of the performance-based compensation is readily ascertainable, any additional payment amount that is not substantially certain to be paid may be treated as performance-based compensation for purposes of the special election timing rule applicable to such compensation.

4. Nonelective Plans

A nonelective deferred compensation plan is a plan in which the employee is not provided with the opportunity to elect the time and form of payment of the deferred compensation; rather, the time and form of payment of the deferred compensation is designated by the employer, often in the plan document. Under the final regulations, the employer must designate the time and form of payment under a nonelective deferred compensation plan by the later of (i) the time the employee first has a legally binding right to the compensation or (ii) the time the employee would have been required to make the election if the employee had the opportunity to make such election.

5. Separation Pay

The final regulations provide a special initial deferral election rule with respect to separation pay paid upon separation from service (whether involuntary or voluntary) where the separation pay is the subject of bona fide arm's-length negotiations at the time of separation. Under this rule, the initial deferral election may be made at any time up to the time the employee obtains a legally binding right to the separation payment.

The final regulations caution that this initial deferral election rule applies only to a legally binding right that arises as part of the process of separating from service and does not apply where the employee obtained a legally binding right to the separation pay **before** the negotiations at the time of the separation from service.

6. Commissions

An initial deferral election must generally be made prior to the year in which the compensation is earned. In order to simplify the application of this requirement for deferrals of sales

commissions, the final regulations treat a commission as having been earned in the year in which the customer pays the employer. The final regulations further simplify the application of the initial deferral election rule to commissions by permitting a commission to be treated instead as earned in the year in which the sale occurred if this rule is applied consistently to all similarly situated employees.

The final regulations also provide for the application of the initial deferral election rule to certain investment commissions which are calculated based on the increase in value, or maintenance of overall value, of a pool of assets or accounts. For this purpose, the services to which the investment commissions relate are treated as being performed over the 12 months preceding the date as of which the overall value of the investment assets is calculated for purposes of determining the amount of the investment commissions.

B. Subsequent Elections Regarding a Change in the Time and Form of Payment

Section 409A and the final regulations permit deferred compensation plans to allow participants to make changes in the time and form of distributions with respect to previously deferred compensation under certain circumstances. Under the "subsequent deferral election rule," in general, the plan may permit a participant to delay a payment or change the form of payment if (i) the change is not effective for at least 12 months after the date on which the new election is made; (ii) the payment is delayed for at least five years from the date that the payment would otherwise have been made (other than payments on account of death, disability, or unforeseeable emergency); and (iii) if the change modifies an election relating to a payment to be made at a specified time (or pursuant to a fixed schedule), the election must be made at least 12 months before the date of the first scheduled payment.

1. Life Annuities

If a deferred compensation plan provides for payment in different forms of life annuities that are actuarially equivalent (which often occurs in nonqualified defined benefit plans), the final regulations treat such annuities as a single form of payment for purposes of the subsequent deferral election rule. Accordingly, a participant's change from one form of annuity to another, before any annuity payment has been made under the plan, is not considered a change in the time and form of payment and, thus, not subject to the subsequent deferral election rule.

The final regulations clarify the circumstances under which actuarial equivalent life annuities may be treated as a single form of payment for purposes of the subsequent deferral election rule. In this regard, the final regulations generally provide that certain annuity features are disregarded in determining whether a particular annuity is treated as a life annuity for purposes of the single form of payment rule. The specified annuity features that are disregarded include: (i) "term certain" features under which annuity payments continue for the longer of the life of the annuitant or a fixed period of time; (ii) "pop-up" features under which payments increase upon the death of the beneficiary or another event that eliminates the right to a survivor annuity; (iii) certain types of cash refund features; (iv) Social Security (or Railroad Retirement) leveling features; and (v) features providing for cost-of-living adjustments. Although the final regulations permit these features to be disregarded, the regulations note that a life annuity with any such feature may be treated as the same form of payment as a life annuity without such feature only if the two life annuities are actuarially equivalent (taking into account the feature) and have the same payment commencement date.

Benefit payments in the form of a joint and survivor annuity are generally treated as a single form of payment with life annuities for purposes of the subsequent deferral election rule. The final regulations clarify that a subsidized joint and survivor annuity is also treated as actuarially equivalent to the single life annuity, provided that neither the annual lifetime annuity benefit nor the annual survivor benefit available under the joint and survivor annuity is greater than the annual lifetime benefit available under the single life annuity.

2. Domestic Relation Orders

The final regulations provide that the subsequent deferral election rule does not apply to changes in the time and form of payment to an alternate payee (such as an ex-spouse, child or dependent) made pursuant to a domestic relations order so long as the change does not modify the payment to the employee. Thus, for example, a domestic relations order may generally provide for a new time and form of payment to a spouse or former spouse.

Time and Form of Payment

A deferred compensation arrangement within the scope of section 409A must provide that compensation will not be paid before one or more of the following events or times: separation from service; disability; death; a time or fixed schedule specified at the time of deferral; a change of ownership of the employer (to the extent specified in regulations); or the occurrence of an unforeseeable emergency. The final regulations are helpful in making some of these requirements easier to comply with, and also clarify certain hazards that must be avoided.

With respect to payments triggered by separation from service, the final regulations have added more detailed rules for when a termination of employment will occur in situations where an employee's hours are reduced but the employee continues a regular relationship with the company as a service provider. More generally, phrases such as "separation from service," "disabled," and "a change in the ownership or effective control of the corporation" that are used in section 409A clearly remain terms of art that, by reason of the Code provision itself or the regulations, have meanings different from, and frequently narrower than the meanings assigned to these terms by other Code provisions or in non-tax contexts. Failure to modify distribution provisions in a pre-section 409A deferred compensation arrangement to comply with the section 409A definitions by the January 1, 2008, effective date of the regulations may result in a finding that the arrangement is not in compliance with section 409A.

A. Separation from Service

In general, a separation from service is presumed to have occurred if no further services are performed after the date of separation, or the level of the employee's services decreases to no more than 20 percent of the average level of services performed in the immediately preceding 36-month period. An employee will be presumed *not* to have separated from service if the level of services performed continues at a level that is 50 percent or more of the level of services performed by the employee in the immediately preceding 36-month period.

For purposes of the rules relating to the definition of separation from service, in general, the "employer" includes the person for whom the services are performed and other persons with

whom that person would be considered a single employer under the standards of sections 414(b) and 414(c), including corporations and other entities with respect to which there is a commonality of ownership interest of, for these purposes, at least 50 percent. A plan may provide, however, that the controlled group standard will be applied with another percentage greater than 50 percent (but not more than 80 percent); or, on the basis of legitimate business criteria, that a standard of less than 50 percent (but at least 20 percent) will apply for these purposes.

B. Specified Time or Fixed Schedule

With respect to a deferred compensation arrangement that provides for payment on a fixed date, it was not initially clear whether the arrangement would be considered as not being operated in accordance with the requirements of section 409A if payments were made a few days, weeks or months before the fixed date. The final regulations address this by providing that a payment will be considered to have been made at a scheduled time if it is made no earlier than 30 days before the scheduled time.

Also, in general, where payment is to be made upon on a specified event (such as separation from service), the arrangement may further provide that payment will be made within a specified period of not more than 90 days following the event triggering the distribution, or at a later date within the same taxable year of the employee. A payment made within the permissible interval will then be considered to have been made in a manner consistent with the requirements of section 409A.

Some plans impose an overall cap on the payments to be made under a compensation arrangement for a particular period, with the cap being a fixed amount or an amount computed by reference to, for example, the employer's sales, profits or cash flow for the same period. The final regulations clarify that such a limitation will not cause the arrangement to fail to meet the requirements of section 409A relating to a fixed payment or schedule of payments, so long as all of the factors relating to this arrangement are beyond the control of the employee and not subject to the exercise of discretion by the employer, and the limitation is established at or before the time that the time and form of payment is required to be established under the regulations.

An arrangement that provides for a payment schedule for payments to an employee that is determined by reference to the timing of the receipt of payments by the employer (from a person not related to employer) may meet the fixed time or schedule requirements, so long as: (i) the payments arise from bona fide and routine transactions in the ordinary course of business of the employer; (ii) the employee does not have effective control of the employer, the person from whom the payments are to be received, or the collection of these amounts; (iii) the plan includes a nondiscretionary method of identifying the underlying payments and the related payments to the employee; (iv) the plan provides for an objective, nondiscretionary schedule for the payments to be made to the employee; and (v) the payments to the employee result from sales of a type that the employer makes routinely, and must either take all employer sales into account or reflect legitimate nontax business reasons for identifying any specific sales taken into account.

Many compensation arrangements provide for employees to receive under specified circumstances a "tax gross-up payment" to reimburse the employee for all or a designated portion of the federal, state, local, or foreign taxes imposed on the employee as a result of compensation paid by the employer. The final regulations provide that such payments will comply with the specified time or fixed schedule distribution requirement of section 409A if the agreement or plan pursuant to which the gross-up payments are made provides that the payment is to be made by the end of the taxable year following the taxable year in which the related taxes are remitted to the taxing authority. The reimbursement of expenses incurred because of an audit or litigation will comply with the above-referenced distribution requirement of section 409A if the payment is made by the end of the employee's taxable year following the year in which the taxes are remitted to the taxing authority or, if no taxes are remitted, by the end of the employee's year following the year in which the tax audit or litigation is completed.

C. Six-Month Delay for Specified Employees

A plan must provide, in general, that distributions to a "specified employee" will not be made before the date that is six months after the date of the employee's separation from service or, if earlier, the date of death (the "six-month delay rule").

A specified employee is, generally, an employee who, as of the date of separation from service, is a "key employee" under section 416(i)(1), with respect to an employer any stock of which is publicly traded on an established securities market (whether domestic or foreign). Any officer of an employer having annual compensation of more than $145,000 for 2007 (adjusted for cost of living) may be a key employee; regardless of compensation levels, no more than 50 employees of an employer are regarded as key employees. The final regulations have lengthy and specific rules concerning the "specified employee identification date" determining the end of the period as of which specified employees are to be identified (such date being December 31, unless otherwise specified) and the period for which such identification is effective (in general, for 12 months commencing with the first day of the fourth month following the identification), as well as with respect to how these rules apply in the context of corporate combinations and divestitures.

Under the final regulations, an arrangement will not fail to be established and maintained in accordance with the requirements of section 409A merely because it does not set forth the six-month delay rule if each employee with a right to compensation is not a specified employee (*e.g.*, because the employer is not publicly traded); but a written provision for the six-month delay rule must be added to such a plan in the event that an employee covered by the arrangement becomes a specified employee. It seems likely that the best practice will be to include a six-month delay rule in almost all deferred compensation arrangements where the employee may conceivably become a specified employee at some time over the duration of the deferred compensation arrangement, with a six-month delay being imposed either in all circumstances to which the rule is relevant or only in the event of a determination by the employer that the employee is a specified employee.

Deferred compensation payments made by reason of a distribution event other than a separation from service (*e.g.*, at a fixed time without regard to employment status) are not subject to the six-month delay. Also excluded from this rule are payments that are not considered to be a deferral of compensation, such as the exercise of a stock option or stock appreciation right covered by the safe harbor, payments made under qualifying separation pay plans excluded from these requirements, qualifying in-kind benefits and reimbursements, and payments accelerated in a manner consistent with the requirements of the final

regulations (*e.g.*, in compliance with a domestic relations order or an ethics agreement with the federal government).

D. Manner of Payment upon a Permissible Payment Event

The final regulations provide further guidance on the extent to which a deferred compensation plan may provide for payment on various distribution events and for a different manner of payment based on the nature of the trigger event. In general, a plan may provide for payment on the earliest or latest of more than one event or time, as long as each event or time is a permitted distribution event, and may provide for a different time and form of payment upon the occurrence of each event or time.

In general, a plan may specify only one time and form of payment with respect to a single event. With respect to a deferral providing for payment upon an employee's separation from service, however, a different time and form of payment may be specified with respect to each of the following situations: (i) separation from service within a period of up to two years following a change of control; (ii) separation from service before or after a specified date or attaining a specified age (or combination of age and period of service); and (iii) separation from service under any other circumstance. Employers maintaining compensation arrangements providing for elective deferrals, and updating their plans to comply with the final regulations, should also consider to what extent their deferral election procedures should be updated to make these alternatives available to their employees.

E. Payments Based on Unforeseeable Emergency

The final regulations elaborate upon when a distribution may be made from a deferred compensation plan by reason of an unforeseeable emergency. Taking into account amendments made by the Pension Protection Act of 2006, an unforeseeable emergency is defined as a severe financial hardship to the employee that results from: (i) an illness or accident of the employee, spouse, beneficiary (under the deferred compensation plan) or dependent of the employee; (ii) a loss of property (such as the employee's primary residence or a portion thereof) due to casualty; or (iii) other extraordinary and unforeseeable circumstance arising from events beyond the control of the employee. Examples in the regulations of such emergencies include medical expenses and an imminent foreclosure on the employee's primary residence. The purchase of a home or payment of college tuition will generally not qualify as an unforeseeable emergency.

A distribution is not permissible under this provision to the extent the emergency may be relieved through other funds available to the employee through reimbursement or compensation from insurance, by liquidation of assets of the employee that may be liquidated without severe financial hardship, or the cessation of deferrals under the deferred compensation plan. However, the determination of the amounts reasonably necessary to satisfy the emergency need not take into account other funds that, due to the emergency, are available to the employee under other nonqualified deferred compensation plans.

Prohibition of Accelerated Payments

A. Plan Terminations

Except as otherwise provided in regulations, a plan subject to section 409A may not permit the acceleration of the time or schedule of any payment under the plan. Accordingly, the termination of a deferred compensation plan may be precluded if the termination would otherwise cause the acceleration of payment of amounts previously deferred. The final regulations expand and clarify certain exceptions to this general rule in the context of plan terminations. Specifically, payment may be accelerated pursuant to a termination of a plan in accordance with any of the following:

(i) a termination of a plan within 12 months after a corporate dissolution and liquidation governed by section 331, or with the approval of a bankruptcy court, if all amounts are distributed and included in the employees' incomes within certain time periods specified in the regulations;

(ii) a termination of a plan by the employer within 30 days before, or within 12 months after a change of control event, provided that all other plans sponsored by the same employer that would be aggregated under the plan aggregation rules summarized above are terminated with respect to each participant affected by the change of control event; or

(iii) a termination of a plan by the employer that does not occur proximate to a decline in the financial health of the employer, if all plans sponsored by the same employer that would be aggregated under the aggregation rules are terminated, no payments are made by reason of the termination within 12 months of the date all necessary action is taken to terminate the plan, all payments are made within 24 months of the date all necessary action is taken to terminate the plan, and the employer does not adopt a new plan (that would be aggregated with the terminated plans if the same employee participated in both plans) at any time within 3 years after the employer takes all necessary action to terminate the former plan.

B. Other Permissible Acceleration Payment Events

A payment or series of payments under a deferred compensation plan may also be accelerated under circumstances including the following:

- to comply with a domestic relations order;
- to permit a federal government employee in the executive branch to comply with an ethics agreement, or to avoid a violation of another applicable ethics law of conflicts of interest law;
- to cash out plan balances not in excess of a specified amount ($15,500 for 2007, adjusted for cost of living);
- to pay FICA and certain other employment taxes;
- in the event of an acceleration of income inclusion by reason of failure to meet the requirements of section 409A;
- if state, local or foreign taxes arise from an amount deferred under the plan before that amount is distributed, to the extent of such taxes due as a result of participation in the plan;
- to satisfy a debt owed by the employee to the employer, up to a maximum of $5,000; and
- in connection with a settlement of a bona fide dispute whether an employee is entitled to a deferred amount (with a presumption that a payment does not meet this exception if the reduction in the present value of the payment, in relation to what would have been paid absent any dispute, is less than 25 percent).

In addition, the final regulations provide that deferral elections may be canceled following an unforeseeable emergency, following a hardship distribution under a section 401(k) plan, or following the date the employee incurs a disability.[8]

Effective Dates

The final regulations are applicable for taxable years beginning on or after January 1, 2008, and taxpayers may also rely on these regulations for earlier taxable years. In general, the transitional relief under prior IRS guidance will not apply after December 31, 2007. Failure to comply with section 409A will result in onerous tax consequences, including acceleration of income and the imposition of an additional 20-percent tax. Accordingly, it is imperative that all deferred compensation arrangements subject to section 409A be reviewed and brought into compliance with section 409A and the final regulations by December 31, 2007.

1. Although the final regulations refer to the deferral of compensation paid by "service recipients" to "service providers," for purposes of this article, service recipients are referred to as employers and service providers as employees.
2. Treas. Reg. § 1.409A-1(b)(4)(iii), example 5.
3. Treas. Reg. § 1.409A-1(b)(4)(iii), example 6.
4. A window program is a program established by an employer to make separation pay available to employees who separate from service over a specified period of no longer than 12 months.
5. The plan aggregation rules do not apply for this purpose. Treas. Reg. § 1.409A-1(c)(3)(viii).
6. Treas. Reg. § 1.409A-2(b)(9), example 5.
7. The final regulations define performance-based compensation as compensation the amount of which, or the entitlement to which, is contingent on the satisfaction of pre-established organizational or individual performance criteria relating to a performance period of at least 12 consecutive months.
8. For this purpose, a disability may consist of a physical or mental impairment that results in the service provider's inability to perform the duties of his position or any substantially similar position (Treas. Reg. §1.409A-3(j)(4)(xii)) – a more liberal definition of disability than that which applies for most other purposes under the section 409A regulations.