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"In this newsletter, we will first provide a relatively brief, high level outline of the Section 409A rules, after which we will provide a more detailed summary of those rules."

SECTION 409A: A NIGHTMARE OF COMPLEXITY

by
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In the fall of 2004, Congress added important new rules governing the taxability of nonqualified deferred compensation plans as part of the American Jobs Creation Act of 2004 (the "AJCA"). Those rules, which apply harsh tax consequences to arrangements failing to satisfy them, are found in Section 409A of the Tax Code. They are, accordingly, often referred to simply as the "Section 409A" rules.

Under the new rules, employees' elections to defer compensation generally must be made by December 31 of the year preceding the year in which the services are performed for which the compensation would otherwise be paid. So, for example, under this general rule, elections would need to be made by December 31, 2007, to defer bonuses paid for 2008 services, even if those bonuses would not be determined and paid until 2009. In addition, the rules generally require that any election to defer compensation specify how and when the payments will ultimately be made.

In this newsletter, we will first provide a relatively brief, high level outline of the Section 409A rules, after which we will provide a more detailed summary of those rules. In the more detailed analysis we have taken into account final regulations the IRS issued in April 2007, which addressed many, though certainly not all, the issues of concern under the new rules.

Note that although we have included a fairly lengthy discussion of the new rules in the detailed analysis that is the second part of this newsletter, we have necessarily failed to address many issues one should consider. In particular, we have been selective in the topics we have chosen to address, and even for those, our analysis is necessarily incomplete given the hundreds of pages of regulations and other guidance the IRS has issued to date.

I. EXECUTIVE SUMMARY

Compensation Subject to Section 409A. The new deferral compensation provisions of Section 409A restrict the deferral of compensation in many ways. The new rules apply not only to voluntary elections to defer compensation, but also to compensation an employer chooses to defer, without any employee election, such as benefits under a supplemental executive retirement plan ("SERP") designed to supplement an employer's qualified retirement plan. The new rules also apply broadly to many other types of deferred compensation, including deferrals under individual employment agreements. The rules can even apply to deferred compensation arrangements with independent contractors.

"The new rules generally do not apply to nontaxable amounts."

The new rules generally do not apply to nontaxable amounts. In addition, the rules generally do not apply to annual bonuses (or other annual compensation) paid within two and one-half months after the end of the calendar year in which the services were provided for which the bonuses (or other compensation) are paid. The new rules can, however, apply to annual bonuses paid more than two and one-half months after year-end, as well as to severance pay.

Here are some of the other rules Section 409A imposes on deferred compensation arrangements:

Events Triggering Distribution. Under Section 409A, deferred compensation may not be distributed earlier than:

- **Separation from Service**
- **Disability**
- **Death**
- A "**Specified Time** (or pursuant to a **Fixed Schedule**)" specified under the plan at the date of the deferral of compensation
- A **Change in Ownership** or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation, as provided in IRS regulations
- The occurrence of an **Unforeseeable Emergency**

Specified Time. As noted in the list above, payments under a nonqualified deferred compensation plan may be made at a "specified time." Amounts payable upon the occurrence of an event are *not* treated as payable at a specified time. For example, amounts payable when an individual attains age 65 are payable at a specified time, while amounts payable when an individual's child begins college are payable upon the occurrence of an event and not at a specified time. Payment at the time distribution is made under an employer's 401(k) or other qualified retirement plan (such as a defined benefit pension plan or profit sharing program) also would not be considered payment at a specified time or pursuant to a fixed schedule, and therefore would not satisfy the new Section 409A requirements of the AJCA.

Disability. A participant is disabled for purposes of the distribution rules if the participant (a) is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, or (b) is, by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident or health plan covering employees of the employer.

Unforeseeable Emergency. For purposes of the distribution rules, an "unforeseeable emergency" is a severe financial hardship to a participant resulting from an illness or accident of the participant, the participant's spouse, or a tax dependent of the participant; a loss of the participant's property due to casualty; or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. In the event of an unforeseeable emergency, the amount distributed must not exceed the amount necessary to satisfy the emergency, plus amounts necessary to pay taxes reasonably anticipated as a result of the distribution, after taking into account the extent to

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"In general, elections to defer compensation for services rendered during a calendar year must be made no later than the close of the preceding calendar year."

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which the hardship is or may be relieved through reimbursement or compensation by insurance or otherwise or by liquidation of the participant's assets (to the extent the liquidation of those assets would not itself cause severe financial hardship).

Acceleration of Benefits. No acceleration of benefits or the payment of benefits is permissible, except as permitted under IRS regulations. A plan may, however, permit the acceleration of the payment of benefits to an individual other than the participant (such as to a former spouse) as necessary to satisfy a domestic relations order, and may permit the acceleration of distribution to the extent necessary to pay certain taxes on the deferred compensation.

Deferral Election Timing Rules. In general, elections to defer compensation for services rendered during a calendar year must be made no later than the close of the preceding calendar year. This rule applies to voluntary deferrals of compensation, such as under typical bonus deferral programs or 401(k) tandem plans. Similar timing rules apply to compensation an employer chooses to defer for its employees (without employees making a voluntary election to defer), if those employees have a choice as to when and how distribution is made. Those employee elections as to the timing and form of distribution are subject to the new election deadlines.

The general rule that deferral elections must be made before the beginning of the year in which the employee's services are provided is relaxed for the first year in which a participant becomes eligible to participate in a deferred compensation plan. In that event, a participant may make an election within 30 days after the date he or she becomes eligible. Even then, however, the election may only be made with respect to compensation paid for services to be performed after the election.

There is another special rule, which may be of use under bonus deferral programs. Where performance-based compensation is based on services performed over a period of at least 12 months, a participant's deferral election may be made as late as six months prior to the end of the service period. So, for example, for performance-based bonuses based on services performed over a calendar year, deferral elections could be made as late as June 30 of the year during which the services are performed.

Certain Changes in Distribution Elections Permitted. In the case of both voluntary deferrals and non-voluntary deferrals, participants may be permitted to make later elections to further defer (but not accelerate) distribution in certain circumstances. Under these rules, later elections to delay a payment or change the form of a payment may be made if:

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

2. In the case of an election relating to a payment that is not on account of disability, death, or unforeseeable emergency, the plan requires that the payment with respect to which the election is made be deferred for a period of at least five years from the date the payment would otherwise have been made; and

3. The plan requires that any election relating to a payment to be made at a specified time (or pursuant to a fixed schedule) not be made less than 12 months prior to the date of the originally scheduled payment.

"[T]he amount required to be included in income is subject to a 20 percent additional tax."

Consequences of Failing to Meet New Rules. Amounts deferred under a nonqualified deferred compensation plan that does not meet the new requirements will be taxed to the extent they are not subject to a substantial risk of forfeiture. For many plans, this will cause participants to be taxed when they vest. In addition to current income inclusion, interest at the Tax Code's underpayment rate plus one percentage point will be imposed on underpayments that would have occurred had the compensation been properly reported as taxable when first deferred or, if later, when no longer subject to a substantial risk of forfeiture (typically, when participants vest). In addition, the amount required to be included in income is subject to a 20 percent additional tax.

Effective Date of New Rules. The new rules are technically effective for amounts deferred after December 31, 2004. The IRS has, however, issued certain transition relief (some of which is discussed in the detailed analysis below). For purposes of the rules' effective date, amounts are treated as deferred on or before December 31, 2004 – and therefore not subject to the new rules – only if before January 1, 2005, the participant had a legally binding right to be paid the amounts and the participant's right to those amounts was earned and vested. In most cases, the result of this rule will be to apply the new rules to amounts that are not vested by December 31, 2004. Earnings on amounts deferred before January 1, 2005, also are not subject to the new rules. Amounts deferred before January 1, 2005 ("grandfathered amounts") become subject to the new rules if the plan under which those deferrals occur is materially modified after October 3, 2004. In general, plan amendments necessary to conform deferred compensation arrangements to the Section 409A rules need not be adopted until December 31, 2007.

New Distribution Elections. A plan can be amended by December 31, 2007, to permit participants to make new elections concerning when and how previously deferred amounts will be distributed, if those previously deferred amounts are subject to the new Section 409A rules. These elections would need to be made by December 31, 2007. Certain restrictions apply, including a prohibition on deferring payment of amounts that would otherwise be paid in 2007 to a later year, or causing payments to be made in 2007 that would otherwise have been made in a later year.

II. DETAILED ANALYSIS

In this portion of the newsletter we will offer a more detailed discussion of five major topics addressed by IRS regulations interpreting Section 409A. Readers may also wish to consult our earlier newsletters on the Section 409A rules, dated October 18, 2006, and February 19, 2005, available at our website, www.utzmiller.com. The five topics are:

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

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What Deferred Compensation is Subject to the New Rules?

"The 409A rules apply not only to the deferral of compensation by employees, but also to deferred compensation arrangements with other service providers, such as independent contractors."

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

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

In addition, the 409A rules generally do not apply to independent contractors providing significant services to at least two service recipients, if those service recipients are unrelated to one another and unrelated to the independent contractor. This exception does not apply where the services provided by the independent contractor are management services. For this purpose, management services are services involving actual or de facto direction or control of the financial or operational aspects of the service recipient's trade or business, or investment management or advisory services provided to a service recipient whose primary trade or business includes the management of financial assets (including investments in real estate), such as a hedge fund or real estate investment trust.

The regulations offer a safe harbor under which an independent contractor providing services to multiple service recipients that are unrelated to one another, and to whom the independent contractor is not related, will be treated as providing significant services to more than one service recipient (so the Section 409A rules do not apply). Under this safe harbor, an independent contractor will be treated as providing significant services to more than one service recipient, and will therefore be exempt from the 409A rules, if not more than 70 percent of the total revenue generated by the trade or business in the taxable year is derived from any one service recipient (or any single group of related service recipients). Under an additional safe harbor, an independent contractor that has actually met the 70 percent threshold just described in the three immediately previous years is deemed to meet the 70 percent threshold for the current year (and, therefore, to avoid the application of Section 409A), 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.

Where an independent contractor qualifies for the 70 percent safe harbor just described with respect to arrangements with unrelated service recipients, Section 409A also will not apply to an arrangement between the independent contractor and a service recipient related to the independent contractor, if certain requirements are met. That will be the case if the arrangement, and the practices under the arrangement, are bona fide, arise in the ordinary course of business, *"[T]he 409A rules generally do not apply to independent contractors providing significant services to at least two service recipients, if those service recipients are unrelated to one another and unrelated to the independent contractor."*

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and are substantially the same as arrangements and practices (such as billing and collection practices) applicable to one or more unrelated service recipients to whom the independent contractor provides substantial services and that produce the majority of the total revenue that the independent contractor earns from the trade or business of providing those services during the year.

If at the time an independent contractor's legally binding right to a payment arose, the deferred compensation arrangement was not subject to Section 409A because the independent contractor was eligible for the independent contractor exclusion under the rules just described, the amount deferred under the arrangement during that taxable year (and earnings credited to the deferred amount) will not become subject to Section 409A in a later year if the service provider becomes an employee, independent contractor, or other type of service provider that is subject to the rules of Section 409A.

Where an individual participates in some arrangements as an employee and in others as an independent contractor, such as might occur where an individual provides services as an independent contractor (and participates in an arrangement in that connection), and then becomes eligible for and defers amounts under a separate employee arrangement after being hired as an employee, the two arrangements will not be aggregated under the plan aggregation rules described later in this newsletter.

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

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

As to employee-directors (that is, inside directors), the 409A rules apply separately to the employee's services as a director and to his or her services as an employee, so long as the director arrangement is substantially similar to arrangements provided to outside directors.

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

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

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A legally binding right to an amount that will be not be taxable when and if received generally does not constitute a deferral of compensation. This means nontaxable amounts generally are not subject to the 409A rules. A right to a nontaxable amount will, however, constitute a deferral of compensation if the employee (or other service provider) has received the right in exchange for a taxable amount (other than due to participation in a cafeteria plan), or has the right to exchange the right for a taxable amount.

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

Compensation will not be considered subject to unilateral reduction or elimination merely because the compensation may be reduced or eliminated by operation of the objective terms of the plan, such as under a nondiscretionary, objective provision creating a substantial risk of forfeiture. Similarly, an employee (or other service provider) does not fail to have a legally binding right to compensation merely because the amount of the compensation is determined under a formula that provides for benefits to be offset by benefits under another plan (such as a qualified retirement plan) or because benefits are reduced due to actual or notional investment losses, or, under a final average pay plan, subsequent decreases in compensation.

Short-Term Deferrals. In a very important exception, the 409A rules do not apply to short-term deferrals. A short-term deferral occurs if the plan does not provide for a "deferred payment" and the employee actually or constructively receives the payment by the later of (a) 2-1/2 months from the end of the *calendar year* in which the amount is no longer subject to a substantial risk of forfeiture, or (b) 2-1/2 months from the end of the *employer's taxable year* in which the amount is no longer subject to a substantial risk of forfeiture. For an amount that is not subject to a substantial risk of forfeiture, but is instead immediately vested, the amount is considered no longer subject to a substantial risk of forfeiture on the date the employee first has a legally binding right to the amount. The payment is treated as actually or constructively received if the payment is taxable (that is, includible in income).

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

A plan provides for a "deferred payment," and therefore does not enjoy the benefit of the short-term deferral rule, if the plan provides for a payment that will be made or completed after a date or an event that will *or may* occur later than the end of the applicable 2-1/2 month period, either because of an affirmative election on the part of the employee or employer or a deferral condition inherent in the terms of the plan (for example, that the amount will be

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paid upon the employee's separation from service, which may occur in a future year). So, for example, if a plan provided for payment upon separation from service, and that separation from service could occur later than the applicable 2-1/2 month period, the short-term deferral rule would not apply to avoid the application of Section 409A. Similarly, if a plan provides that payment will be made upon death, disability, or a change of control event, the short-term deferral rule would not apply where that event could occur later than the end of the applicable 2-1/2 month period.

In general, in determining whether payment could be made later than the applicable 2-1/2 month deadline, any right of an employee (or other service provider) or the employer to elect a different payment date, schedule, or event, is disregarded. So, if the default under a plan is to provide for a deferred payment, there will be a deferred payment spoiling the ability to use the short-term deferral rule even if the participant in fact elects that payment occur within the applicable 2-1/2 month period. If, however, the plan's default does not provide for a deferred payment (but instead provides for payment that will occur within the applicable 2-1/2 month period), but the employee or employer makes an election as to when payment will be made, whether there is a deferred payment will be determined based on the payment date, schedule, or event actually elected by the employee or employer.

The regulations extend the 2-1/2 month deadline where timely payments are not administratively practicable or financially feasible. In particular, a payment made after the 2-1/2 month deadline can continue to be treated as meeting the short-term deferral exception if (a) it was administratively impracticable to make payment by the end of the 2-1/2 month period, and as of the time the legally binding right to the compensation arose, this impracticability was unforeseeable, or (b) making the payment by the end of the 2-1/2 month period would have jeopardized the ability of the employer to continue as a going concern. Payment must, however, be made as soon as practicable or as soon as the payment would no longer jeopardize the employer's ability to continue as a going concern. There is a similar delay permitted where an employer reasonably anticipates that it will not be permitted to deduct the payment by reason of the $1 million limitation on compensation under Tax Code Section 162(m), and a reasonable person would not have anticipated this at the time the legally binding right to the payment arose. In that event, payment must be made as soon as reasonably practicable after the employer anticipates, or reasonably should anticipate, that the payment would no longer be nondeductible by reason of Section 162(m).

Example 1. **(Bonus Plan; Does Not Specify Payment Date)** On November 1, 2008, Employer Z awards a bonus to Employee A such that Employee A has a legally binding right to the payment as of November 1, 2008, that is not subject to a substantial risk of forfeiture. The bonus plan does not provide for a payment date or a deferred payment. The bonus plan will not be considered to have provided for a deferral of compensation if the bonus is paid or made available to Employee A on or before March 15, 2009.

Example 2. Employer Y has a taxable year ending August 31. On November 1, 2008, Employer Y awards a bonus to Employee B so that Employee B has a legally binding right to the payment as of November 1, 2008, that is not subject to a substantial risk of forfeiture. The bonus plan does not provide for a payment date or a deferred payment. The bonus plan will not be considered to have provided for a deferral of compensation if the bonus is paid or made available to Employee B on or before November 15, 2009.

Example 3. **(Bonus Subject to Substantial Risk of Forfeiture; Subsequent Deferral Election)** On November 1, 2008, Employer X awards a bonus to Employee C such that Employee C has a legally binding right to the payment as of

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November 1, 2008. Under the bonus plan, Employee C will forfeit the bonus unless Employee C continues performing services through December 31, 2010. The right to the payment is subject to a substantial risk of forfeiture through December 31, 2010. Employee C has the right to make a written election not later than December 31, 2009, to receive the bonus on or after December 31, 2015, but Employee C does not make such election. The bonus plan does not provide for a default payment date or a deferred payment in the absence of an election by Employee C. The bonus plan will not be considered to have provided for a deferral of compensation if the bonus is paid or made available to Employee C on or before March 15, 2011.

Example 4. **(Employment Required on Scheduled Payment Date)** On November 1, 2008, Employer W awards a bonus to Employee D such that Employee D has a legally binding right to the payment as of November 1, 2008. Under the bonus plan, the bonus will be determined based on services performed during the period from January 1, 2009 through December 31, 2010. The bonus is scheduled to be paid as a lump sum payment on February 15, 2011. Under the bonus plan, Employee D will forfeit the bonus unless Employee D continues performing services through the scheduled payment date (February 15, 2011). Provided that at all times before the scheduled payment date Employee D is required to continue to perform services to retain the right to the bonus, and the bonus is paid on or before March 15, 2012, the bonus plan will not be considered to have provided for a deferral of compensation.

Example 5. **(Payment Date After Applicable 2-1/2 Month Period)** On November 1, 2008, Employer V awards a bonus to Employee E such that Employee E has a legally binding right to the payment as of November 1, 2008. Under the bonus plan, Employee E will forfeit the bonus unless Employee E continues performing services through December 31, 2010. Under the bonus plan, the bonus is scheduled to be paid as a lump sum payment on July 1, 2011. By specifying a payment date after the applicable 2-1/2 month period, the bonus plan provides for a deferred payment. The bonus plan provides for a deferral of compensation, and will not qualify as a short-term deferral regardless of whether the bonus is paid or made available on or before March 15, 2011 (and generally any payment before July 1, 2011 would constitute an impermissible acceleration of a payment).

Example 6. **(Payment Upon Separation)** On November 1, 2008, Employer U awards a bonus to Employee F such that Employee F has a legally binding right to the payment as of November 1, 2008, that is not subject to a substantial risk of forfeiture. The bonus plan provides for a lump sum payment upon Employee F's separation from service. Because the separation from service is an event that may occur after the applicable 2-1/2 month period, the bonus plan provides for a deferred payment and therefore provides for a deferral of compensation. Accordingly, the bonus plan will not qualify as a short-term deferral regardless of whether Employee F separates from service and the bonus is paid or made available on or before March 15, 2009.

Example 7. **(Life Annuity)** On November 1, 2008, Employer T grants Employee G a legally binding right to the payment of a life annuity with the first annuity payment on November 1, 2013, provided that Employee G continues performing services for Employer T continuously through November 1, 2013. Because the life annuity is treated as a single payment, and because all payments of the life annuity may not occur during the applicable 2-1/2 month period, the plan provides for a deferred payment and none of the amounts payable under the annuity will qualify as a short-term deferral, so that section 409A applies to all amounts that are payable under the plan.

Example 8. **(Discounted Stock Right)** On November 1, 2008, Employer S grants Employee H a stock right providing for an exercise price less than the fair market value of the underlying stock on November 1, 2008. The stock right is subject to a substantial risk of forfeiture requiring services through November 1, 2010. The stock right becomes exercisable when the substantial risk of forfeiture lapses and expires on November 1, 2013. Employee H continues providing services through November 1, 2010, at which time the substantial risk of forfeiture lapses. The stock right provides for a deferred payment and will not qualify as a short-term deferral regardless of whether Employee H exercises the stock right on or before March 15, 2011.

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

As noted, IRS regulations provide special, more favorable, rules for certain separation pay plans. For this purpose, a separation pay plan is a plan that provides "separation pay." Where a plan provides both amounts that are separation pay and amounts that are not separation pay, the portion of the plan that provides separation pay will be considered a separation pay plan. The term "separation pay" means any deferral of compensation that will not be paid under any circumstances unless the employee (or other service provider) has had a separation from service, whether that separation is voluntary or involuntary. This includes payments in the form of reimbursements of expenses incurred, and the provision of in-kind benefits. If an employee (or other service provider) may receive compensation without a separation from service, that compensation does not become separation pay merely because the employee elects to receive, or in fact receives, the payment after or upon a separation from service. Compensation does not fail to be separation pay merely because the payment is conditioned upon the execution of a release of claims, noncompetition or nondisclosure provisions, or other similar requirements.

Involuntary Terminations and Window Program Payments. The regulations offer a useful exception from the 409A rules for separation pay arrangements providing payment upon *involuntary* separation. Under this exception, to the extent payments upon involuntary separation (or pursuant to a window program) do not exceed (a) two times the employee's annualized compensation, based on the employee's annual rate of pay for the calendar year before the year in which the employee separates from service, adjusted for any increase during that prior year that was expected to continue indefinitely, or (b) if less, two times the annual dollar limit on compensation taken into account under qualified retirement plans in effect for the year of separation ($225,000 for calendar year 2007), Section 409A will not apply. The plan must, however, require that payments be made no later than the end of the second calendar year following the year in which the employee terminates service. These dollar limits and time limitations for payment are akin to the limits set forth in Department of Labor regulations establishing a safe harbor under which severance programs subject to ERISA will be welfare plans, rather than pension plans, and thereby avoid application of ERISA's vesting and funding requirements.

A "window program," to which this same exception can apply, is a program established by an employer in connection with an impending separation

"IRS regulations provide substantial relief for severance plans. . .."

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from service to provide separation pay, where the program is made available by the employer for limited period of time (no longer than 12 months) to employees who separate from service during that period or to employees who separate from service during that period under specified circumstances. A program will not be considered to be a window program if the employer establishes a pattern of repeatedly providing for similar separation pay in similar situations for substantially consecutive, limited periods of time. Whether the recurrence of these programs constitutes a pattern is determined based on the facts and circumstances. Although no one factor is determinative, relevant factors include whether the benefits are on account of a specific business event or condition, the degree to which the separation pay relates to the event or condition, and whether the event or condition is temporary or discrete, or is instead a permanent aspect of the employer's business.

Involuntary Separation from Service. As noted, this exception from the application of the 409A rules applies only to payments upon *involuntary* separation (or pursuant to a window program). An involuntary separation from service means a separation from service due to an independent exercise of the unilateral authority of the employer to terminate the employee's services. It does not include a termination due to the employee's implicit or explicit request, where the employee was willing and able to continue performing services. An involuntary separation from service may include an employer's failure to renew a contract at the time the contract expires, provided that the employee (or other service provider) was willing and able to execute a new contract with terms and conditions substantially similar to those in the expiring contract (and to continue providing those services).

Any characterization of a separation from service as either voluntary or involuntary that is made by the employer and employee in the documentation of the separation is presumed to be accurate. This presumption may, however, be rebutted where the facts and circumstances indicate otherwise. For example, if a separation from service is designated as a voluntary separation or resignation, but the facts and circumstances indicate that absent such voluntary separation from service the employer would have terminated the employee, and the employee had knowledge that he or she would be so terminated, the separation from service is involuntary.

Separation for Good Reason. A voluntary separation from service will be treated as an involuntary separation in certain circumstances. This can be important in determining whether the exception from the 409A rules just described (for limited payments upon involuntary termination) applies. It may also be important in determining whether compensation is considered to be subject to a substantial risk of forfeiture (as discussed more fully below). That is because, generally, compensation payable only by reason of an involuntary termination without cause is subject to a substantial risk of forfeiture until and unless that involuntary termination without cause occurs.

An employee's voluntary separation from service will be treated as an involuntary separation if it occurs under certain limited bona fide conditions, where the avoidance of the requirements of Section 409A is not a purpose of the inclusion of those conditions in the plan or the actions by the employer in connection with the satisfaction of those conditions, and a voluntary separation from service under those conditions effectively constitutes an involuntary separation from service. Generally these conditions will be pre-specified under an agreement to provide compensation upon a separation from service for "good reason." Good reason (or any similar condition) must be defined in a way that requires the employer to take action resulting in a material negative change to the employee in his or her employment, such as in the duties to be performed by the employee, the conditions under which those duties are to be performed, or the compensation to be received for performing those services. Other factors taken into account in determining whether a separation from service for good reason effectively constitutes an involuntary separation from service include the extent to which the payments upon separation for good reason are in the same amount and are to be made at the same time and in the same form as payments available upon an actual involuntary separation from service, and whether the employee is required to give the employer notice of the existence of the condition that would result in treatment as a separation from service for good reason and a reasonable opportunity to remedy the condition.

"The regulations provide a safe harbor, under which a plan may provide that a voluntary separation from service will be treated as an involuntary separation . . .."

The regulations provide a safe harbor, under which a plan may provide that a voluntary separation from service will be treated as an involuntary separation if the separation occurs under certain express conditions which include the following:

1. 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 employee:

    a. a material diminution in the employee's **base compensation**,

    b. a material diminution in the employee's **authority, duties, or responsibilities**,

    c. a material diminution in the authority, duties, or responsibilities of the **supervisor** to whom the employee is required to report, including a requirement that the employee report to a corporate officer or employee instead of reporting directly to the board of directors of the corporation (or similar governing body with respect to an entity other than a corporation),

    d. a material diminution in the **budget** over which the employee retains authority,

    e. a material change in the **geographic location** at which the employee must perform the services, or

    f. any other action or inaction that constitutes a **material breach of agreement** by the employer of the agreement under which the employee provides services.

2. 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 a right exists.

3. The employee must be required to provide notice to the employer of the existence of the condition described in (1) above within a period not to exceed 90 days of the initial existence of the condition, and upon giving that notice the employer 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.

<u>Short-term Deferral Rule and Separation Pay on Involuntary Termination</u>. An employee's right to a separation payment will be considered a nonvested right if the amount is payable only upon involuntary termination without cause (as discussed more fully in the section below on "Substantial Risk of Forfeiture"). As a result, even if payments under an involuntary separation pay

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arrangement (paying only upon involuntary termination without cause) do not qualify for the exception to the 409A rules described earlier (in the section on "Involuntary Terminations and Window Program Payments"), the arrangement may be structured to meet the requirements of the short-term deferral exception, and in that way avoid the application of Section 409A.

"IRS regulations exempt certain reimbursement arrangements from the 409A rules . . .."

Expense Reimbursements. The regulations address the application of Section 409A to payments that constitute reimbursements of a terminated employee's expenses under a separation pay plan (including a plan providing payments upon voluntary separation). Because the promise to reimburse a former employee will not be contingent on the employee's provision of any substantial services, a right to reimbursement generally will not be treated as being subject to a substantial risk of forfeiture. As a result, if the period during which incurred expenses will be reimbursed extends beyond the year in which the legally binding right arises, the right to that reimbursement generally would constitute deferred compensation. Although the IRS has refused to grant a categorical exclusion from the application of Section 409A to reimbursement arrangements, IRS regulations exempt certain reimbursement arrangements from the 409A rules to the extent those reimbursements cover only expenses incurred before the end of the second calendar year following the calendar year in which the employee has a separation from service.

The types of reimbursements excluded from the application of Section 409A include reimbursements for expenses that the employer can deduct as ordinary business expenses, as well as reasonable outplacement expenses and reasonable moving expenses actually incurred by an employee and directly related to the employee's termination of employment. Moving expenses may include the reimbursement for any loss an employee actually incurs due to the sale of his or her primary residence in connection with a separation from service. This special relief for reimbursements also applies to an employer's provision of in-kind benefits, and direct payments to a person providing goods or services to a terminated employee, if the provision of these in-kind benefits or direct payments would be treated as reimbursement arrangements were the employee to have paid for them and received reimbursement from the employer. In-kind benefits are services provided to or on behalf of an employee, such as financial planning services, or tangible personal or real property made available for use by or on behalf of the employee, such as the use of an aircraft or vehicle.

As noted above, for expense reimbursements to be excluded from the Section 409A rules, the reimbursement right must apply only to expenses incurred during a limited period of time. The limited period of time during which expenses may be *incurred*, or in which in-kind benefits may be provided by the employer or a third party that the employer will pay, may not extend beyond the last day of the second calendar year following the year in which the separation from service occurred. In addition, the period during which the reimbursements for those expenses will be *paid* may not extend beyond the third year following the year in which the separation from service occurred.

Medical Benefits. As indicated earlier, nontaxable amounts are generally not subject to Section 409A. As a result, Section 409A will not apply to the provision of continued medical coverage following a separation from service unless those benefits are taxable. Note, however, that medical expense reimbursements may be taxable under a discriminatory self-insured health plan that fails to meet the nondiscrimination rules of Section 105(h) of the Tax Code. Even as to taxable medical reimbursements, to the extent a separation pay plan (including a plan providing payments due to a voluntary separation from service) entitles an employee to reimbursement by the employer of payments of medical expenses that are incurred and paid by the employee, but not reimbursed by a person other than the employer, and that are allowable as a deduction (ignoring the 7.5 percent of adjusted gross income threshold for medical deductions),

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[T]he exclusions . . . for certain separation pay arrangements do not apply to the extent separation pay acts as a substitute for, or replacement of, amounts that would otherwise be subject to Section 409A."

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Section 409A will not apply to the provisions of those benefits. This exception applies only to the extent the right to reimbursement applies during the period of time during which the employee would be entitled to COBRA coverage if the employee elected that coverage.

De Minimis Amount. In addition to the exceptions to Section 409A applicable to separation pay described above, the 409A rules do not apply to payments to an employee under a separation pay plan to the extent, in the aggregate, those payments do not exceed the dollar limit under Tax Code Section 402(g)(1)(B) in effect for the year of the separation from service ($15,500 for 2007).

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

It can be difficult to determine what constitutes a substitute for deferred compensation where an employee receives a payment at separation from service and at that time forfeits other deferred compensation to which the employee had a legally binding, though unvested, right. Whether the payment made upon separation acts as a prohibited acceleration of vesting and substitute payment for the amount of deferred compensation forfeited, or whether the deferred compensation is instead treated as forfeited and the amount paid is treated as a separate payment of current compensation (which may qualify for the various special and favorable rules for separation pay), is determined based on the facts and circumstances. Where, however, the separation from service is voluntary, it is presumed that the payment results from an acceleration of vesting followed by a payment of the deferred compensation that is subject to Section 409A. Accordingly, any change in the payment schedule to accelerate or defer the payments would be subject to the 409A rules, including the general prohibition on acceleration. This presumption that a right to payment is not a new right, but is instead a right substituted for a preexisting forfeited right, may be rebutted by demonstrating that the employee would have obtained the right to the payment regardless of the forfeiture of the nonvested right. A factor indicating that the employee would have obtained a right to a payment regardless of the forfeiture of the nonvested right is that the amount to which the employee obtains a right is materially less than the present value of the forfeited amount, multiplied by a fraction. The numerator of that fraction is the period of service the employee actually completed, and the denominator is the full period of service the employee would have been required to complete to receive the full amount of the payment. So, for example, where an employee is entitled to a future payment only if he or she completes three years of service and at the time of termination he or she has completed one year of service, the presumption would be rebutted if the payment to the employee is materially less than the present value of one third of the nonvested amount. Another factor indicating that the employee would have received the payment even if he or she had not forfeited other deferred compensation is that the payment the employee receives is of a type customarily made to employees who separate from service with the employer and who do not forfeit nonvested rights of deferred compensation, such as, for example, a payment of accrued but unused leave or a payment for a release of actual or potential claims.

Indemnification and Liability Insurance. There has been concern that providing executives or other employees with indemnification protection might result in the deferral of compensation subject to Section 409A, particularly where that protection extends beyond separation from service. Fortunately, IRS regulations provide generally that the right to the payment of contingent amounts pursuant to an employee's indemnification for expenses incurred as a result of a legal claim for damages related to the employee's performance as an employee of the employer, to the extent permissible under applicable law, will not be treated as the right to deferred compensation. Similarly, a right to liability insurance coverage providing for such payments in the event of such a lawsuit also will not be treated as providing for a deferral of compensation.

"Nondiscounted nonqualified stock options and stock appreciation rights . . . are not subject to Section 409A."

Legal Settlements. IRS regulations address the application of Section 409A to amounts paid pursuant to litigation between an employee and an employer, including court awards and bona fide settlements, and including amounts characterized as wages or otherwise treated as replacing compensation. The regulations generally provide that Section 409A does not apply to settlements or awards resolving bona fide legal claims based on wrongful termination, employment discrimination, the Fair Labor Standards Act, or workers' compensation statutes, regardless of whether those claims arise under federal, state, local, or foreign laws, and even where the settlements or awards pursuant to those claims are treated as compensation for federal tax purposes. In addition, the regulations generally provide that Section 409A does not apply to the payment of, or reimbursement for, attorneys' fees incurred in connection with the enforcement of such a claim. However, this exception covers only rights arising from a bona fide claim, and is not intended to allow settlements or awards to act as substitutes for, or to allow for the restructuring of, preexisting deferred compensation subject to Section 409A. For example, a change to the timing of the payment of a preexisting amount of deferred compensation as part of such a settlement would be subject to the rules governing accelerated payments and subsequent deferral elections. In addition, the payment of an amount upon the execution of a waiver of any or all claims does not necessarily indicate that the amounts are paid as an award or settlement of an actual bona fide claim. Rather, to qualify for the exception for legal settlements, the amounts must be paid with respect to an actual bona fide claim for damages under applicable law.

Educational Benefits. There had been some concern about the application of Section 409A to promises to provide future taxable educational benefits to employees. These benefits typically would be provided as an inducement to provide services for a period of time. Some had expressed concern that the amount and timing of the payment of those benefits would be difficult to ascertain, because the amount and timing would depend upon the employee's decisions with respect to further education. In response, the IRS regulations provide that Section 409A does not apply to taxable educational benefits, where the benefits consist solely of educational assistance (as defined in Tax Code Section 127(c)) provided solely for the education of the employee. This exception does not apply to benefits provided for the education of an employee's spouse, child, other family member, or any other person.

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

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

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an option includes a feature for the deferral of compensation other than the deferral of taxation to the later of the date of exercise or the time the stock acquired first becomes substantially vested. The regulations refer to stock options and stock appreciation rights collectively as "stock rights."

The exception from the 409A rules for nondiscounted nonstatutory stock options is generally intended to cover only options granted on common stock of the employer that is the service recipient. Stock to which the option relates generally may not include any preference as to distribution other than distributions in liquidation. The regulations provide guidance on when stock rights can, without losing their 409A exemption, nevertheless be based on (a) stock of a related company (generally, applying the Tax Code's controlled group rules using a 50 percent, rather than 80 percent, ownership standard), or (b) stock of a company with an ownership interest in a joint venture, when compensating employees of the joint venture (generally permissible where the owning company has at least a 20 percent ownership interest, subject to certain special rules).

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

Plan Aggregation Rules. The provisions of Section 409A are applied on an individual participant basis. As a result, where the requirements of 409A are violated with respect to a participant, that individual suffers adverse tax consequences, but the violation does not disqualify the arrangement as to other participants. Where, however, the 409A requirements are violated with respect to an individual under one plan, all amounts deferred by the individual under the same type of plan are aggregated and the employee is subject to adverse tax consequences on the aggregated amount. The regulations establish nine types of plans for purposes of these aggregation rules (with different types of contributions being treated as different plans in some cases, as in 1 and 2 below). Those plan types are as follows:

1. Elective Contributions to Account Balance Plans
2. Nonelective Contributions to Account Balance Plans
3. Nonaccount Balance Plans
4. Involuntary Separation Pay Plans and Window Programs
5. Reimbursements (and In-kind Benefits)
6. Split Dollar Life Insurance
7. Amounts Treated as Modified Foreign Income
8. Stock Rights
9. All Other Deferrals of Compensation.

"[D]eferred compensation arrangements subject to Section 409A [must] be set forth in writing."

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Written Plan Requirement. The regulations establish a requirement that deferred compensation arrangements subject to Section 409A be set forth in writing. A plan is considered established on the latest of (a) the date on which it is adopted, (b) the date on which it is effective, or (c) the date on which the material terms of the plan are set forth in writing. The material terms of a plan may be set forth in writing in one or more documents. Those material terms include the amount (or the method or formula for determining the amount) of deferred compensation to be provided under the plan and the time and form of payment. Although generally a plan will not be considered established until its material terms are set forth in writing, a plan will be deemed to be established as of the date a participant obtains a legally binding right to a deferral of compensation, so long as the plan is actually established (under the rules just described) by (a) the end of the year in which the legally binding right arises, or (b) with respect to an amount not payable in the year immediately following the year in which the legally binding right arises (the subsequent year), the 15th day of the third month of the subsequent year.

If employees are permitted to make initial deferral elections, the plan must set forth in writing, on or before the date the employee's election is required to be irrevocable, the conditions under which the election may be made. If a plan permits subsequent deferral elections, the plan must set forth in writing, on or before the date such an election is required to be irrevocable, conditions under which those elections may be made.

In limited circumstances described later in this newsletter, payments may be accelerated. A plan generally is not required to set forth in writing the conditions under which payment may be accelerated.

As discussed later, distributions upon separation from service must be delayed for six months for certain employees known as "specified employees." Where those rules apply, a plan must provide that distributions to a specified employee may not be made before the date that is six months after the date of separation from service, or, if earlier, the employee's date of death. This six month delay must be written in the plan. A plan does not fail to satisfy this requirement merely because it does not contain the six month delay rule, if the employee who has a right to compensation deferred under the plan is not a specified employee. The rule must, however, be set forth in writing on or before the date the employee first becomes a specified employee. In general, this means the provision must be set forth in writing on or before what is known as the "specified employee effective date" (described later in this newsletter) for the first list of specified employees that includes the employee.

In the case of an amendment that increases the amount deferred under a plan, the plan is not considered established with respect to the additional amount until the plan, as amended, is established under the rules described above. Under a transition rule, a legally enforceable unwritten plan that was adopted and effective before December 31, 2007, is treated as established as of the later of the date on which it was adopted or became effective, provided that the material terms of the plan are set forth in writing on or before December 31, 2007. Although plans of the same type are normally aggregated, deferrals under a plan that fails to meet the requirements of Section 409A solely due to a failure to meet the written plan requirements will not be aggregated with deferrals under other plans of the same type that do satisfy the written plan requirement.

The IRS had been asked whether a plan could comply with the 409A rules by use of a "savings clause," where the savings clause provides that each provision of the plan will be interpreted to be consistent with the requirements of Section 409A and any provision of the plan that does not satisfy those requirements will be of no force or effect. Under IRS regulations, such a provision

"An employee's obligations under a noncompete agreement will not, by themselves, constitute a substantial risk of forfeiture."

would not be adequate to comply with 409A requirements. In particular, IRS regulations provide that for purposes of determining the terms of a plan, general provisions of the plan that purport to nullify noncompliant plan terms, or to supply required specific plan terms, are disregarded. As a result, if a plan contains terms that do not meet the requirements of Section 409A, or fail to contain a plan term necessary to meet the requirements of those rules, the plan will violate the requirements of Section 409A regardless of whether the plan contains a savings clause.

The IRS had also been asked to publish model amendments for use in complying with the requirements of Section 409A. When issuing regulations in April 2007, the IRS indicated that it did not believe it feasible to publish model amendments at that time due to the complex and varied universe of deferred compensation plans.

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

A payment conditioned on an involuntary separation from service without cause will be subject to a substantial risk of forfeiture if there is a substantial risk that the employee will not be involuntarily separated from service without cause.

An employee's obligations under a noncompete agreement will not, by themselves, constitute a substantial risk of forfeiture. That is, an amount will not be considered subject to a substantial risk of forfeiture merely because the employee's right to that amount is conditioned on the employee refraining from the performance of services (as, for example, agreeing not to compete with the employer). In addition, a requirement that an employee sign a release of claims to receive a benefit does not create a substantial risk of forfeiture. More generally, conditions under the discretionary control of an employee (other than the decision whether or not to continue providing services) do not create a substantial risk of forfeiture.

In general, plan amendments that extend a substantial risk of forfeiture will not be recognized. In particular, so called "rolling risks of forfeiture," under which an employer or employee may periodically extend, or roll, the risk of forfeiture, will be disregarded in determining whether an employee's compensation is subject to a substantial risk of forfeiture. More generally, the addition of any risk of forfeiture after the legally binding right to compensation arises, or any extension of a period during which compensation is subject to a substantial risk of forfeiture, is disregarded for purposes of determining whether compensation is subject to a substantial risk of forfeiture.

An amount will not be considered subject to a substantial risk of forfeiture beyond the date or time at which the employee otherwise could have elected to

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

In determining whether the possibility of forfeiture is substantial, special rules apply where the employee owns a significant amount of equity in the employer. In particular, where the employee owns a significant amount of the total combined voting power of value of all classes of equity of the employer, all relevant facts and circumstances will be taken into account in determining whether the probability of the employer enforcing the condition is substantial.

"IRS regulations . . . clarify that the Section 409A rules apply even where an employee has no choice whatsoever as to the amount deferred, or the time or form of payment."

What are the Initial Deferral Election Requirements?

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

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

Nonelective Arrangements. The statute is not clear concerning the election rules that apply to nonelective deferred compensation. IRS regulations, however, clarify that the Section 409A rules apply even where an employee has no choice whatsoever as to the amount deferred, or the time or form of payment. In this circumstance, the plan must, no later than the time the employee first has a legally binding right to the compensation, specify the time and form of payment.

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

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To enjoy the extended election deadline for performance-based compensation, the employee must perform services continuously from the later of (a) the beginning of the performance period, or (b) the date the performance criteria are established, through the date the employee's election is made. In addition, no election may be made after the compensation has become readily ascertainable. For this purpose, if performance-based compensation is a specified or calculable amount, the compensation will be readily ascertainable if and when the amount is first substantially certain to be paid. If the performance-based compensation is not a specified or calculable amount because, for example, the amount may vary based upon the level of performance, the compensation, or any portion of the compensation, is readily ascertainable when the amount is first both calculable and substantially certain to be paid. For this purpose, performance-based compensation is bifurcated between the portion that is readily ascertainable and the amount that is not readily ascertainable. As a result, in general, any minimum amount that is both calculable and substantially certain to be paid will be treated as readily ascertainable.

"An exception to the general rule requiring that deferral elections be made by the prior December 31 applies to 'performance-based' compensation . . .."

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

Performance criteria may be established (in writing) up to 90 days after commencement of the period of service to which the criteria relates, if the outcome is substantially uncertain at that time. Recall, though, that at the time of an initial deferral election, the amount of the compensation must not be readily ascertainable.

The attainment of a prescribed value for the employer (or a portion thereof), or a share of stock of the employer, may be used as a performance-based criterion, if it is a condition for receiving the compensation. If an amount of compensation is not based solely on an increase in the value of the employer's stock after the grant or award (for example, as with restricted stock units or a stock right grant with an exercise price that is less than the fair market value of the stock as of the date of grant), none of the compensation attributable to the grant or award will be performance-based compensation unless the other amount itself qualifies as performance-based compensation. As a result, compensation that is equal to a predetermined number of shares of stock, and that is variable only to the extent the value of those shares increases or deceases, generally will not be performance-based. Nonetheless, such an award of equity-based compensation may constitute performance-based compensation if entitlement to the compensation is itself subject to a performance-based vesting condition.

We discussed earlier the exception from the 409A rules for nondiscounted stock rights. That exception applies only where the stock rights have no feature for the deferral of compensation other than that inherent in the nature of a stock option or SAR. In contrast, a stock right with a deferral feature is subject to Section 409A from the date of grant. The arrangement would, therefore, need to specify a permissible payment time and a form of payment. This requirement will not be met if, at some point during the term of the stock right, the stock right

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becomes immediately exercisable and the employee may decide whether and when to exercise the right. In addition, where a deferral feature is added to an existing stock right, the stock right generally will violate Section 409A because it will have a deferral feature and will not have specified a permissible payment time or event.

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

"The normal December 31 deadline for initial deferral elections is relaxed for newly eligible participants."

Generally, where an employee is rehired or changes position so as to cease participating in a plan, and then is rehired or transfers back to a position permitting participation, the extended deadline for new participants will not apply. That is because if the employee did not receive a full distribution from the plan previously, he or she will still be considered to be a participant by reason of his or her right to benefits previously earned. IRS regulations do, however, permit such an employee to be treated as newly eligible if the employee has not been an active participant in the plan (applying the plan aggregation rules) for at least 24 months. For this purpose, an employee is an active participant if, under the plan's terms and without further amendment or action by the employer, the employee is eligible to accrue benefits (even if the employee has elected not to participate in the plan), other than earnings on amounts previously deferred. In addition, where an employee has been paid all amounts deferred under a plan, and on and before the date of the last payment was not eligible to continue (or to elect to continue) to participate in the plan for periods after the last payment (other than through an election of a different time and form of payment with respect to the amounts paid), the employee may be treated as initially eligible to participate as of the first date following that payment when the employee becomes eligible to accrue an additional amount of deferred compensation.

Excess Benefit Plans. Commentators had requested relief with respect to the timing rules for initial elections establishing the time and schedule of payments under nonelective excess benefits plans. Commentators noted that under those plans, an employee often automatically becomes a participant when the employee's benefits under a qualified plan become limited under the Tax Code's rules governing those plans. Because determining whether an employee is a participant requires calculations, commentators observed that both the employee and employer may be unaware that the employee has become a participant for some time after the employee actually first becomes eligible. As a consequence, IRS regulations generally provide that with respect to a nonelective "excess benefit plan," an employee is treated as initially eligible to participate as of the first day of the calendar year immediately following the first calendar year the employee accrues a benefit. As a result, an initial deferral election with respect to the time and form of payment may be made effective for benefits accrued for services performed during the year immediately preceding the year in which the election is made. This rule may only be used once with respect to an employee's participation in a plan.

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"Where a separation pay arrangement is negotiated . . . at the time of [an] employee's involuntary separation . . . an initial deferral election [may] be made . . . even though that payment will relate primarily to services already provided."

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The term "excess benefit plan" means all plans in which an employee participates, to the extent those plans do not provide for an election between current compensation (including a short-term deferral) and deferred compensation, and solely provide deferred compensation equal to the excess of (a) the benefits the employee would have accrued under a qualified plan in which the employee also participates in the absence of one or more of the limits incorporated into the plan to reflect one or more of the limits on contributions or benefits applicable to qualified plans under the Tax Code, over (b) the benefits the employee actually accrues under the qualified plan. For this purpose, the term qualified plan includes not only qualified retirement plans, but also Section 403(b) tax sheltered annuities, Section 457(b) plans, simplified employee pensions, and simple retirement accounts.

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

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

<u>Individually Negotiated Severance Agreements</u>. Where a separation pay arrangement is negotiated with a particular employee at the time of the employee's involuntary separation from service, IRS regulations permit an initial deferral election to be made with respect to that separation pay event even though that payment will relate primarily to services already provided. More particularly, where separation pay due to an involuntary termination has been the subject of bona fide, arms-length negotiations between an employer and employee, the employee may make an election as to the time and form of payment, if the election is made on or before the date the employee obtains a legally binding right to the payment. In contrast, this special rule does not apply

"[A] special deadline [can] apply to initial deferral elections for compensation paid by employers with fiscal years other than the calendar year."

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to any separation pay to which the employee obtained a legally binding right before the time of the separation pay negotiations. This would include, for example, a pre-existing right to a payment upon separation other than for cause. In the case of separation pay due to participation in a window program (described earlier in this newsletter), an initial deferral election may be made at any time before the election to participate in the window program becomes irrevocable.

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

Despite the 12-month requirement, this rule permitting initial deferral elections as much as 30 days after the date of grant is available even if the right to the compensation may vest earlier than 12 months following the employee's election due to the employee's death or disability, or due to a change of control. However, if death, disability, or a change of control occurs and the employee vests before the end of the 12-month period, the deferral election may be given effect only if the deferral election would be permitted under the regulations' normal rules, without resort to this special rule for certain forfeitable rights.

Initial Deferral Election for Fiscal Year Compensation. The legislative history to Section 409A suggests that a special deadline should apply to initial deferral elections for compensation paid by employers with fiscal years other than the calendar year. The regulations establish such a rule, generally permitting an initial election to defer fiscal year compensation to be made on or before the end of the fiscal year immediately preceding the first fiscal year in which any services are performed for which the compensation is paid. For this purpose, fiscal year compensation does not, however, include all compensation paid by a fiscal year employer. Where compensation is not specifically based upon an employer's fiscal year as the measurement period, the normal timing requirements applicable to initial deferral elections described above would apply unchanged. As a result, the special rule applies to compensation that is based on service periods that are co-extensive with one or more of the employer's consecutive fiscal years, where no amount of the compensation is payable during that service period. For example, a bonus based upon a service period of two consecutive fiscal years, payable after the completion of the second year, would be fiscal year compensation. In contrast, periodic salary payments or bonuses based on service periods other than the employer's fiscal year would not be fiscal year compensation, and the deferral of those amounts would be subject to the general timing rule for initial deferral elections.

Commissions. The regulations include special rules for commissions. The applicable rules are intended to address the difficulty employees and employers may have in determining when the services related to a particular commission payment began, and the resulting difficulty in knowing how to apply the general rule that a deferral election must be made before the year in which any services are performed.

Where a commission arrangement (a) requires that an employee be providing services at the time of the payment to be entitled to a payment, (b) the commission is paid in the normal course, and (c) neither the employee nor the employer has a right to specify a payment date, the arrangement generally will not provide for the deferral of compensation. Section 409A will, therefore, not apply.

Where commission compensation is deferred compensation to which Section 409A applies, the regulations set forth a series of rules addressing when deferral elections may be made. Under these rules, an employee will be treated as having performed the relevant services to which sales commission compensation relates only in the year in which the customer remits payment to the employer or, if applied consistently to all similarly situated employees, the year in which the sale occurs. This permits an employee to make an initial deferral election with respect to commission compensation as late as December 31 of the calendar year preceding the year in which the customer remits payment, or, under a consistently applied rule, December 31 of the calendar year preceding the year in which the sale occurs.

These special rules apply to "sales commission compensation," which is compensation or portions of compensation earned by an employee where (a) a substantial portion of the services provided by the employee consist of the direct sale of a product or service to an unrelated customer, (b) the compensation paid by the employer to the employee consists of either a portion of the purchase price for the product or services or an amount substantially all of which is calculated by reference to the volume of sales, and (c) the payment of the compensation is either contingent upon the employer receiving payment from an unrelated customer for the product or services or, if applied consistently to all similarly situated employees, is contingent upon the closing of the sales transaction and such other requirements as may be specified by the employer before the closing. To be an unrelated customer, the customer must not be related to either the employee or the employer.

Another special rule applies where an employee earns "investment commission compensation." This rule was added in response to a request by commentators that the special rules for commission income be extended to commissions earned due to the increase in value, or maintenance of overall value, of a pool of assets or accounts. For such investment commission compensation, an employee is treated as having provided the services to which the compensation relates 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 the calculation of the commission compensation. Investment commission compensation is compensation earned by an employee where a substantial portion of the services provided by the employee consists of sales of financial products or other direct customer services to an unrelated customer with respect to customer assets or customer accounts. Amounts will only be treated as investment commission compensation, however, if (a) the customer retains the rights to terminate the customer relationship and may move or liquidate the assets or asset accounts without undue delay (which may be subject to a reasonable notice period), (b) the compensation consists of a portion of the value of the overall assets or asset account balance, an amount substantially all of which is calculated by reference to the increase in the value of the overall assets or account balance during a specified period, or both, and (c) the value of the overall assets or account balance and investment commission compensation is determined at least annually. The customer is unrelated only if the customer is not related to either the employee or the employer.

The regulations apply these special commission compensation rules even to arrangements involving customers related to the employee or the employer if (a) substantial sales or substantial services occur between the employer and a significant number of unrelated customers, (b) the sales or service arrangement

"The regulations include special rules for commissions."

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"[P]ayments may be made under the Section 409A rules at a fixed date . . . or upon any of five events . . .."

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and the commission arrangement with respect to a customer related to either the employer or the employee are bona fide and arise in the ordinary course of business, and (c) both the terms and practices are substantially the same as the terms and practices applicable to customers to whom the employee and employer are not related, and to whom, either individually or in the aggregate, the employer has made substantial sales or provided substantial services.

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

As noted in the executive summary above, payments may be made under the Section 409A rules at a fixed date or under a fixed schedule, or upon any of five events: a separation from service, death, disability, change in the ownership or effective control of a corporation, or unforeseeable emergency. Where the time of payment is based upon the occurrence of a specified event (such as one of the five events listed above or, as discussed later in the section on "Specified Time or Fixed Schedule of Payments," upon the lapse of a substantial risk of forfeiture), the plan must designate the date of event as the payment date, or specify another payment date that is objectively determinable and nondiscretionary at the time the event occurs. A plan may, alternatively, provide that payment will be made in accordance with a *schedule* that is objectively determinable and nondiscretionary based on the date the event occurs, so long as the schedule is fixed at the time the permissible payment event is designated.

Rather than designating a particular date for payment, a plan may provide that a payment, including a payment that is part of a schedule, will be made during a designated year that is objectively determinable and nondiscretionary at the time the payment event occurs such as, for example, a schedule of three substantially equal payments payable during the first three years following the year in which a separation from service occurs. Similarly, a plan may also provide that a payment, including a payment that is part of a schedule, will be made during a designated period objectively determinable and nondiscretionary at the time the payment event occurs, if (a) the designated period both begins and ends within one year or the designated period is not more than 90 days, and (b) the employee does not have a right to designate the year of the payment (other than through an election that complies with the subsequent deferral election rules described later in this newsletter). Where a plan provides for a period of more than one day following the payment event during which a payment may be made, such as where a plan provides for payment within 90 days following the date of the event, the payment date for purposes of the subsequent deferral rules is treated as the first possible date upon which the payment could be made under the terms of the plan.

A plan may also provide for payment upon the earliest or latest of more than one event or time, so long as each event or time is a permissible time for payment.

Single Time and Form for Each Payment Event. A single time and form of payment must be designated with respect to each amount that is payable upon a payment event. For example, a plan must designate how an amount will be paid upon a control in control, and generally cannot provide one time and form of payment upon a particular type of change of control, with another time and form of payment applying upon another type of control in control. A plan may, however, provide for a different time and form of payment depending on whether the permissible payment event occurs before or after a specified date. In addition, a different time and form of payment may be designated with respect to a separation from service under each of the following conditions:

1. Separation from service during a limited period of time not to exceed two years following a change in control,

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

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2. Separation from service before or after a specified date (for example, the attainment of a specified age), or a separation from service before or after a combination of a specified date, such as attaining a specified age, and a specified period of service determined under a predetermined, nondiscretionary, objective formula or pursuant to the method for crediting service under a qualified plan sponsored by the employer, or

3. A separation from service not described in (1) or (2) above.

Although a plan may provide for a different time and form of payment with respect to one or more of the categories of separation from service described above, the addition or deletion of such a different time and form of payment upon separation from service that applies to an existing deferral will be subject to the subsequent deferral election rules and the anti-acceleration rules, described later in this newsletter.

Payment by Date Administratively Feasible. The IRS has acknowledged that it may not be administratively feasible to make payment upon the exact date designated by a plan. The regulations, therefore, treat a payment as made upon the plan’s designated date if the payment is made by the later of (a) the end of the calendar year containing the designated date, or (b) the 15th day of the third calendar month following the designated date. In addition, a payment will be deemed to have been made at the scheduled time of payment if it is made earlier than the scheduled date, but not more than 30 days earlier, and the employee is not permitted, directly or indirectly, to designate the year of the payment. For purposes of these rules, if the date specified is only a year, or a period of time during a year, the date specified under the plan is treated as the first day of that year or first day of that period.

In addition, where the calculation of an amount of a payment is not administratively practicable due to events beyond the control of the employee or the employee’s estate, payment may be made during the first calendar year in which calculation of the amount of the payment is administratively practicable. The failure of an employee (or employee’s beneficiary) to provide reasonably available information necessary to calculate the amount of a payment will not, however, constitute an event beyond the control of the employee. There is a similar rule where payment would jeopardize the ability of the employer to continue as a going concern. In that event, payment will be treated as made on the plan’s designated date if payment is made during the first calendar year in which the payment would not jeopardize the ability of the employer to continue as a going concern.

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

Specified Time or Fixed Schedule of Payments. Generally, a plan will be deemed to provide for a specified time or fixed schedule of payments where, at the time of deferral, the specific date upon which the payment or payments will be made is nondiscretionary and may be objectively determined. The regulations

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permit plans to simply specify the calendar year or years (or a defined period or periods within a year or years) in which payments are scheduled to be made, without specifying the particular date within a year (or deferred period) on which payment will be made. This raises a question as to how the rules permitting subsequent deferrals operate where a year, rather than a particular date, is specified. The question arises because where an amount is payable at a specified time or per a fixed schedule, and the plan permits a delay in payment under a subsequent election, the plan must require that the subsequent election be made at least 12 months prior to the date of the first scheduled payment. So, where only a year of distribution is specified, when is the first scheduled payment considered to occur? For a plan that designates only the year in which payment is to be made (rather than a specified date), the first scheduled payment is, under the regulations, deemed to be scheduled to be paid as of January 1 of that year. Similarly, where payment is to be made in a designated period, the first scheduled payment is deemed to be made as of the first day of that designated period.

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

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

A special rule applies with respect to disability leave. In that case, the employment relationship will be treated as continuing for a period of up to 29 months, unless otherwise terminated by the employer or the employee, regardless of whether the employee retains a contractual right to reemployment. For this purposes, a special definition of disability is used. This definition differs from the normal definition applicable under the permissible payment event rules. In this context, disability leave refers to leave due to the employee's inability to perform the duties of his or her position of employment or any substantially similar position of employment by reason of any medially determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than *six* months.

Whether an employee has experienced a termination of employment is to be determined based on the particular facts and circumstances. The IRS does not intend that the standard for separation from service permit the extension of deferrals through the use of consulting agreements or other devices under which an employee technically agrees to perform services as demanded, but for which there is no intent that the employee actually perform any significant services. As a result, the general standard for determining whether an employee has

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terminated employment is based on whether the facts and circumstances indicate that the employer and employee reasonably anticipated either that no further services would be performed after a certain date or that the level of bona fide services that the employee would perform after that 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 the full period in which the employee provided services to the employer, whether as an employee or as an independent contractor, if the employee has been providing services for less than 36 months). For this purpose, periods during which the employee is on an unpaid bona fide leave of absence are disregarded (including for purposes of determining the relevant 36 month period), and periods during which the employee is on a paid bona fide leave of absence are treated as periods during which the employee provided services at the level at which the employee would have been required to perform services to receive the compensation if not on a bona fide leave of absence.

The facts and circumstances to be considered in determining whether an employee and employer reasonably anticipated that the employee's future services would be permanently reduced to less than 20 percent of the average level of bona fide service provided during the previous 36 month period include, but are not limited to, (a) whether the employee continues to be treated as an employee for other purposes (such as continuation of salary and participation in employee benefit programs), (b) whether similarly situated service providers have been treated consistently, and (c) whether the employee is eligible to perform services for, and realistically available to perform services for, other employers in the same line of business.

Just as the standard for separation from service is not intended to permit the *extension* of deferrals, it is not intended to permit the *acceleration* of deferrals. In particular, a formal termination of employment may be disregarded for 409A purposes. For example, where an employee continues to provide services to a prior employer in a capacity other than as an employee, such as continuing on as an independent contractor, a separation from service will be presumed as not having occurred if the former employee provides services at an annual rate that is 50 percent or more of the services rendered, on average, during the prior 36 months of employment (or, if the employee was employed for less than 36 months, that lesser period).

The regulations apply a set of rebuttable presumptions in determining whether an employee has separated from service. Those presumptions combine the general 20 percent standard for determining whether there has been a separation from service and the 50 percent presumption for concluding that there has been no separation from service. Specifically, the regulations provide that an employee generally will be presumed to have separated from service where the level of bona fide services performed (whether as an employee or as an independent contractor) decreases to a level equal to 20 percent or less of the average level of services provided during the previous 36 months (whether as an employee or as an independent contractor). An employee will be presumed not to have separated from service where the level of bona fide services rendered continues at a level that is 50 percent or more of the average level of services provided during the previous 36 months. No presumption applies to a decrease in the level of services to a level that is between 20 percent and 50 percent of the average level of services provided during the previous 36 months. For purposes of the presumption, the entire period during which the employee has provided services to the employer is substituted for 36 months if the employee has been providing services to the employer for less than 36 months. Periods during which the employee is on a bona fide leave of absence are treated in the same manner as those periods are treated for purposes of the general rule.

"[T]he regulations allow plans a limited ability to choose the level of reduction in bona fide services that will constitute a separation from service."

As indicated, these presumptions are rebuttable. They may be rebutted by demonstrating that the employer and the employee reasonably anticipated that as of a certain date the level of bona fide services would be reduced permanently to a level less than or equal to 20 percent of the average level of services provided during the immediately preceding 36 month period (or that the level of bona fide services would not be so reduced). For example, an employee may demonstrate that the employer and employee anticipated that the employee would cease providing services, but that (subsequent to the original cessation of services) business circumstances such as termination of the employee's replacement caused the employee to return to employment. Although the employee's return to employment may cause the employee to be presumed to have continued in employment because he or she is providing services at a rate equal to the rate at which he was providing services before the termination of employment, the facts and circumstances in this case would demonstrate that at the time the employee terminated employment, the employee and the employer reasonably anticipated that the employee would not provide any services in the future.

Similarly, where the loss of a business client of the employer results in a permanent reduction in the level of bona fide services performed by the employee of more than 80 percent, so that the employee would be presumed to have separated from service, the employee may rebut the presumption that a separation from service occurred by showing that the employer and the employee reasonably anticipated that the level of services would not be so reduced. The separation from service would then be deemed to occur at the time the employer and employee reasonably anticipated that that reduction would continue.

Despite the rules just described, the regulations allow plans a limited ability to choose the level of reduction in bona fide services that will constitute a separation from service. In particular, the regulations provide that rather than treating a separation from service as requiring an anticipated permanent reduction in the level of bona fide services to 20 percent or less of the average level of bona fide services provided in the immediately preceding 36 months, a plan may treat another level of anticipated permanent reduction in the level of bona fide services as a separation from service, so long as (a) the level of permanent reduction required is set forth in the plan as a specific percentage, and (b) the anticipated permanently reduced level of bona fide services is greater than 20 percent but less than 50 percent of the average level of bona fide services provided in the immediately preceding 36 months. The plan must specify the definition of separation from service on or before the date on which a separation from service is designated as a time of payment of an amount deferred. Once designated, any change to the definition of separation from service with respect to such amount deferred will be subject to the 409A rules regarding subsequent deferrals and the acceleration of payments (described later in this newsletter).

For example, on or before the time at which a plan must designate a time and form of payment for a deferred amount, the plan may specify that a separation from service will be deemed to occur at any time the employee and employer reasonably anticipate that the bona fide level of services that the employee will perform (whether as an employee or an independent contractor) will be permanently reduced to a level that is less than 50 percent of the average level of bona fide services the employee performed during the immediately preceding 36 months (or the entire period the employee has provided services if the employee has been providing services to the employer less than 36 months).

In determining whether an employee has separated from service, the employer is considered to include all entities that are a part of its controlled group (or control group, in the case of noncorporate entities), but determined by substituting the 50 percent ownership level for the normal 80 percent ownership level that applies under the Tax Code's employee benefit provisions. A plan may,

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however, specify that a higher or lower percentage ownership level will be used, so long as the ownership level is not higher than 80 percent or lower than 20 percent, and provided further that an ownership level of less than 50 percent may be used only where that use is based only on legitimate business criteria. A plan doing so must specify the percentage chosen on or before the date at which a separation from service is designated as a time of payment. Where a plan changes the definition of separation from service with respect to amounts previously deferred, that change will be subject to the rules governing changes to the time and form of payment, including the anti-acceleration rules described later in this newsletter.

Where payments of deferred compensation have begun upon separation from service, it would generally not be permissible to suspend those payments upon a subsequent period of reemployment or other service. Such a suspension generally would violate the rules governing the changes in the time and form of payment (because of the resulting delay in payment).

The IRS has made clear that although Section 409A uses the phrase "separation from service," which is the same phrase used under the old "same desk rule" applicable to Section 401(k) plans, the same desk rule does not apply in determining what constitutes a separation from service for purposes of the 409A rules. Nevertheless, the regulations provide that where, as part of a sale of assets by one employer to an unrelated employer, an employee of the seller would otherwise experience a separation from service with the seller, the seller and the buyer may specify whether an employee providing services to the seller immediately before the asset purchase transaction and providing services to the buyer after and in connection with the asset purchase transaction has experienced a separation from service. This is permitted only where (a) the asset purchase transaction results from bona fide, arms-length negotiations, (b) all employees (and other service providers) providing services to the seller immediately before the asset purchase transactions and providing services the buyer after and in connection with the asset purchase transaction are treated consistently (regardless of position at the seller) for purposes of applying the provisions of any plan, and (c) this treatment is specified no late than the closing date of the asset purchase transaction. For this purpose, a sale of assets refers to a transfer of substantial assets, such as a plant or division, or substantially all of the assets of a trade or business.

Directors. Where an individual provides services to an employer both as an employee and as an independent contractor, the individual must separate from service both as an employee and as an independent contractor to be treated as having separated from service. But where an individual provides services both as an employee and a member of the board of directors of a corporate employer, the services provided as a director are not taken into account for purposes of determining whether the individual has a separation from service as an employee for purposes of a plan in which the individual participates as an employee that is not aggregated with any plan in which the individual participates as a director. Accordingly, where an employee-director participates in a separate plan as an employee, his or her termination of services as an employee will constitute a separation from service for purposes of the employee plan, regardless of whether he or she continues providing services as a director (and vice versa). If, however, a non-employee director is also providing additional services as an independent contractor, he or she cannot have a separation from service until he or she has separated from service both as a director and as an independent contractor.

Delay for Specified Employees. Payments upon a separation from service of a "specified employee" must be delayed at least six months following that separation (or, if earlier, to the date of death of the employee). In general, a specified employee is a key employee of a corporation where any stock of the corporation is publicly traded on an established securities market or otherwise.

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The term "key employee" means a key employee under the top-heavy rules applicable to qualified retirement plans. Under those top-heavy rules, key employees are (a) officers having annual compensation greater than $145,000 (this is an inflation-adjusted number; this is the figure for 2007), (b) five percent owners, and (c) one percent owners having annual compensation from the employer of more than $150,000. No more than 50 employees (or, if less, the greater of three or ten percent of the employees) are treated as officers for purposes of these rules. As a result, for most publicly-traded employers subject to the specified employee rules, there will be a maximum of 50 specified employees. In determining an employee's compensation, the definition of compensation under Tax Code Section 415 applies. More particularly, the general definition of compensation under Treasury Regulation Section 1.415(c)-2(a) is used, applied as if the employer were not using (a) any safe harbor provided under Treasury Regulation Section 1.415(c)-2(d), (b) any of the special timing rules provided in Treasury Regulation Section 1.415(c)-2(e), or (c) any of the special rules provided in Treasury Regulation Section 1.415(c)-2(g). However, an employer may use any available definition of compensation under Tax Code Section 415 and the accompanying regulations, including any available safe harbor and any available election under the timing rules or special rules, so long as the definition is applied consistently to all employees of the employer for purposes of identifying specified employees. An employer may elect to use such a definition of compensation regardless of whether another definition is being used for purposes of a qualified plan of the employer. However, once a list of specified employees has become effective, the employer cannot change its definition of compensation for purposes of identifying specified employees for the period with respect to which that list is effective.

The identification of key employees is based on a 12 month period ending on an identification date chosen by the employer (the "specified employee identification date"). Persons who meet the requirements for being key employees during that 12 month period are considered key employees for the 12 month period commencing on the first day of the fourth month following the end of the 12 month period (the "specified employee effective date"). For example, if an employer chooses December 31 as an identification date, any key employees identified during the calendar year ending December 31 would be treated as key employees for the 12 month period commencing the following April 1. Employers may choose an identification date other than December 31, so long as the date chosen is used consistently (and with respect to *all* plans), and provided that any change in the identification date is not effective for a period of at least 12 months. An employer may designate a specified employee identification date in each plan or in a separate document applicable to all plans, provided that the employer will not be treated as designating a specified employee identification date before the designation is legally binding on the employer and all affected employees. Any designation of a specified employee identification date made on or before December 31, 2007, may be applied to any separation from service occurring on or after January 1, 2005, unless and until subsequently changed pursuant to the rules for changing identification dates.

The six month delay requirement applies only where the employee is a specified employee as of the date of separation from service, and does not become applicable if the employee is not a specified employee as of that date but subsequently would have become a specified employee had the separation not occurred.

Special rules apply to the identification of specified employees following a corporate transaction, such as a merger or spinoff. Where two public corporations merge and become one public corporation, or a public corporation becomes a subsidiary of another public corporation, the resulting employer's next specified employee identification date and the first specified employee effective date following the transaction are the specified employee identification date and specified employee effective date that the acquiring employer would have been required to use absent the merger. For the period after the date of the

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transaction and before the next specified employee effective date, the specified employee list of the resulting employer consists of the 50 most highly compensated service providers appearing on the combined list of the two employers' specified employees in effect as of the date of the transaction, ranking those specified employees in order of the amount of compensation used to determine each specified employee's status as a specified employee, plus any one percent and five percent owners not otherwise included who would be treated as specified employees. Alternatively, the resulting employer may use any other reasonable method to determine its specified employees immediately after the transaction, provided that the method is adopted not later than 90 days after the merger and applied prospectively from the date of adoption.

Where a public corporation and a private corporation merge and become a public corporation, or where a private corporation becomes a subsidiary of a public corporation, the resulting employer's next specified employee identification date and specified employee effective date following the transaction will be the specified employee identification date and specified employee effective date that the pre-transaction public corporation would have been required to use absent the transaction. For the time period after the transaction and before the next specified employee effective date, the specified employees of the pre-transaction public employer immediately before the transaction will continue to be the specified employees of the resulting employer, and employees of the pre-merger private employer will not become specified employees until the next specified employee effective date. As a result, the plans in which employees of the formerly private employer participate will not be required to contain a plan term delaying a payment upon separation from service of those employees, or to delay such a payment, until the next specified employee effective date.

The regulations also address spinoff transactions. Where, as part of a corporate transaction, a public employer becomes two separate public employers, the next specified employee identification date and the specified employee effective date of each of the post-transaction employers are the specified employer identification date and specified employee effective date that the pre-transaction employer would have been required to use absent the transaction. For the period after the date of the transaction and before the next specified employee effective date, the specified employees of the pre-transaction employer immediately before the transaction continue to be the specified employees of the post-transaction employers.

The regulations also provide guidance on initial public offerings and other corporate transactions where all or a part of a private employer becomes one or more public employers. In that case, each post-transaction public employer will generally have a December 31 specified employee identification date and an April 1 specified employee effective date. Alternatively, the new public employer may establish a different specified employee identification date and specified employee effective date, provided that the specified employee identification date and specified employee effective date must be established on or before the date of the initial public offering or other corporate transaction.

For the period between the date of the initial public offering or other corporate transaction and the first specified employee effective date, the list of specified employees of each post-transaction public employer comprises the employees that at the time of the corporate transaction or public offering would have been classified as specified employees of the former private employer, had that employer adopted the same specified employee identification date and specified employee effective date as selected by the post-transaction public employer, and had such former private employer been a public employer as of that specified employee identification date.

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"*The regulations set default rules for identifying specified employees, where the employer has not adopted another definition.*"

The regulations set default rules for identifying specified employees, where the employer has not adopted another definition. These default rules include the following: (a) the specified employee identification date is December 31; (b) the specified employee effective date is April 1; (c) the general definition of compensation under Treasury Regulation Section 1.415(c)-2(a) will apply (without giving effect to any special timing rules under Treasury Regulation Section 1.415(c)-2(e) or the safe harbor definition of compensation under Section 1.415(c)-2(d)); and (d) certain rules regarding the identification of specified employees after a merger of public employers or an initial public offering or other transaction involving a formerly nonpublic employer becoming a public employer will apply.

Alternatively, an employer may use other permissible rules and definitions, so long as those alternatives become effective only in accordance with certain rules and deadlines set forth in the regulations. In addition, the regulations permit an employer to use an alternative method for purposes of identifying specified employees, with certain limitations, and to make an election under Treasury Regulation Section 1.415(c)-2(g)(5)(i) regarding the treatment of certain compensation excludable from an employee's gross income due to the location of the services or the identity of the employer. For purposes of these rules, an employer may use one of these alternatives when all necessary corporate action has been taken to make the alternative binding for purposes of all affected deferred compensation plans in which the employees of the employer participate. Accordingly, as a practical matter, an employer may find it expedient to specify the definition of specified employee in all its plans, or to retain the discretion in all its plans to make such determinations and take any necessary corporate action in accordance with each such plan.

Under one of the most important alternatives, a plan may provide for an alternative method for identifying those employees subject to the six month delay rule, so long as (a) the alternative is reasonably designed to include all specified employees (determined without respect to any available employer elections), (b) the alternative method is an objectively determinable standard providing no direct or indirect election to any employee regarding its application, and (c) the alternative method results in either all employees or no more than 200 employees being identified in the class as of any date. Use of such an alternative method will not be treated as a change in the time and form of payment under the subsequent deferral rules described later in this newsletter, even if the employee is not a specified employee when the payment is delayed.

For any employee who is a specified employee as of the date of separation from service, payments may not be made before the date that is six months after the date of separation from service (or, if earlier than the end of the six month period, the date of death of the specified employee). An individual who is not a specified employee as of the date of a separation from service will not be treated as subject to this requirement even if he or she would have become a specified employee if he or she had continued to provide services through the next specified employee effective date. Similarly, an employee who is treated as a specified employee as of the date of his or her separation from service will be subject to the six month delay even if he or she would not have been treated as a specified employee after the next specified employee effective date had he or she continued providing services through that date. The regulations include certain exceptions from the requirement that payments be delayed, such as in the case of payments on account of a domestic relations order, certain conflicts of interest, or for the payment of employment taxes.

The required delay in payment is satisfied if payments to which a specified employee would otherwise be entitled during the first six months following the date of separation from service are accumulated and paid on the first day of the

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seventh month following the date of separation from service. Alternatively, each payment to which a specified employee is otherwise entitled upon separation from service be delayed by six months. An employer may maintain the discretion to choose which method will be implemented, provided that no direct or indirect election as to the method may be provided to the employee.

A plan may provide that a payment will be made, notwithstanding the six month delay, upon an employee's death. Where, however, a payment on account of a separation from service has been delayed because the employee is a specified employee, payment may not be accelerated due to disability, a change in control, or an unforeseeable emergency. Where payment is made to a specified employee on account of disability, a change in control, or an unforeseeable emergency, the payment need not, however, be delayed merely because the specified employee separates from service after incurring the disability or unforeseeable emergency, or after the change in control.

Disability. An employee will be disabled for purposes of the distribution rules if the employee (a) is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, or (b) is, by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident or health plan covering employees of the employer. A plan may provide that an employee will be deemed disabled if he or she is determined to be totally disabled by the Social Security Administration. A plan may also provide that an employee will be deemed disabled if he or she is determined to be disabled in accordance with a disability insurance program, so long as the definition of disability applied under that program is consistent with the disability definition under Section 409A. A plan may provide for a payment upon any disability, and is not required to provide for a payment upon all disabilities.

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

Reimbursements and In-Kind Benefit Plans. Where rights to taxable reimbursements or in-kind benefits are subject to Section 409A, the regulations provide guidance on how those payments can be made consistent with the 409A fixed time and form requirements. A reimbursement plan subject to the 409A rules may only provide for the reimbursement of expenses incurred during an objectively prescribed period (which may include a period beginning or ending based upon an employee's death), where the amount of reimbursable expenses or in-kind benefits available in one calendar year cannot affect the amount of reimbursable expenses or in-kind benefits available in a different calendar year. In addition, any reimbursement payment must be made no later than the end of the calendar year following the year in which the expense is incurred. These reimbursement or in-kind benefit rights may not be subject to liquidation or exchange for another benefit. Under a special rule, arrangements reimbursing medical expenses may provide for an aggregate limit on the benefits provided, such as under a lifetime maximum.

As an example of these rules, a right to a reimbursement of membership fees incurred for each of three specified and consecutive calendar years by a former employee, where the former employee is entitled to reimbursement of the

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expenses incurred each year without regard to the expenses incurred in a different year, and where the former employee cannot exchange the right for cash or any other benefit, generally will be treated as providing for a fixed time and form of payment, if the plan requires that the reimbursement payment be made by no later than the end of the calendar year following the year in which the expense is incurred. In contrast, a right to reimbursement of membership fees of up to $30,000 over three years would not meet the requirement of a fixed time and form of payment, because the extent to which the former employee incurred the expense in the first year would affect the amount of available reimbursement in a subsequent year. This rule applies similarly to the provision of in-kind benefits, such as the right to use a corporate vehicle or aircraft.

"A reimbursement plan subject to the 409A rules may only provide for the reimbursement of expenses incurred during an objectively prescribed period . . .."

Payment Schedules with Fixed or Formula Payment Limitations. Payment schedules with fixed or objective formula limitations on the amount that may be paid during any particular period can meet the requirement of a fixed schedule or time and form of payment. In particular, where (a) a fixed or formula limitation is established on or before the date the time and form of payment is otherwise required to be set, (b) the limitation is based on a fixed or nondiscretionary, objectively determinable formula limitation on the amount that may be paid in a particular period and where all the factors relevant to the determination of that limit are beyond the control of the employee and not subject to any exercise of discretion by the employer, and (c) the plan specifies the time and form of payment of any additional amount due in excess of the fixed or formula limitation amount, the schedule will be deemed to be a fixed schedule of payments. For example, a plan may provide that all payments to all participants in a given year may not exceed $1 million, so long as the plan provides an objective, nondiscretionary method of allocating the $1 million in payments should the amounts otherwise exceed $1 million (such as proportionately to each participant based on the amount otherwise payable absent the limit), and specifies the time and form of payment of any amount not paid currently because of the limitation (such as the earliest time possible without exceeding the applicable limitation for any subsequent year). However, a change in the limits or a change in the allocation method may constitute a subsequent deferral election or an acceleration of a payment.

Where the limit on a payment is calculated pursuant to a formula related to business performance, such as a specified percentage of cash flow for a period, a payment schedule may be conditioned on that formula limitation, so long as (a) the limitation is specified at the time the schedule of payments is otherwise required to be set, (b) the limitation is nondiscretionary and objectively determinable based on the business performance of the employer, and (c) the employee retains no control over the determination or application of the formula limitation. For this purpose, a formula limitation based on profits or other indicia of general business performance is not treated as discretionary or in the control of the employer. Therefore, a plan providing that the maximum payment during a year will equal no more than a set percentage of the employer's cash flow for the previous year generally would meet the requirement of a fixed time and form of payment. However, a change in the formula limitation may constitute a subsequent deferral election or an acceleration of a payment.

A scheduled payment also does not fail to be a fixed schedule where a plan provision reduces a schedule of periodic payments on a dollar-for-dollar basis by the amount of Social Security payments received or receivable, if that reduction does not otherwise affect the time of payment of the deferred compensation, including changes based on the employee's eligibility or elections related to Social Security benefits. Similarly, a plan provision that reduces a schedule of periodic payments on a dollar-for-dollar basis by the amount of bona fide disability pay received or receivable may be treated as a nondiscretionary objective formula limitation, if the disability payments are made pursuant to a plan sponsored by the employer that covers a substantial number of employees and was established before the employee became disabled, and if the reduction

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does not otherwise affect the time of payment of the deferred compensation. Whether an amendment to, or other change to the benefit payable under, such a bona fide disability plan results in an acceleration of a payment or a subsequent election to delay the time or change the form of a payment will be determined based on all the relevant facts and circumstances.

Tax Gross-Up Payments. A right to a tax gross-up payment is a right to deferred compensation that satisfies the requirement of a fixed time and form of payment if the plan provides that the tax gross-up payment will be made, and the payment is made, by the end of the calendar year next following the year in which the related taxes are remitted to the taxing authority. In addition, a right to reimbursement of expenses incurred due to a tax audit or litigation satisfies the requirement of a fixed time and form of payment if the right provides that payment will be made, and the payment is made, by the later of the end of the calendar year next following the year in which the taxes that are the subject of the audit or litigation are remitted to the taxing authority, or, if no taxes are to be remitted, the end of the calendar year next following the year in which the audit or litigation is completed.

Payment Schedules Based on Payments to the Employer. In general, a payment schedule based upon the timing of payments to an employer is not a fixed schedule of payments and therefore does not satisfy the Section 409A requirements. Under the following conditions a plan may, however, qualify as having a fixed time and form of payment for those amounts. First, if the employer comprises more than one entity, the payments must be due from a person that is not one of those entities (in particular, the payment must not be due from a subsidiary corporation to a parent corporation). Second, the payments must stem from bona fide and routine transactions in the ordinary course of business of the employer, and the employee must not at the time those payments are due retain effective control over the employer, the person from whom the payments to the employer are due, or the collection of the payments. Third, the payment schedule must provide for a nondiscretionary, objective method of identifying the customer payments from which the amount of the payment is determined, and a nondiscretionary, objective schedule under which payments of the compensation will be made (for example, providing for a payment every March 1 of 10 percent of the accounts receivable collected during the previous calendar year). Finally, the sales to which the payment relates must be of a type that the employer is in the trade or business of making and makes frequently, and either all such sales must be taken into account or there must be a legitimate, nontax business purpose for limiting the sales taken into account.

Examples: Specified Time or Fixed Schedule

Example 1. **(Payment by December 31 of Year of Separation)** Employee A provides services as an employee of Employer Z but is not a specified employee. Employee A participates in a nonqualified deferred compensation plan providing for a lump sum payment payable on or before December 31 of the calendar year in which Employee A separates from service. The plan provides for a payment upon a separation from service in compliance with this section.

Example 2. **(Payment Within 90 Days Following Separation)** Employee B provides services as an employee of Employer Y, but is not a specified employee. Employee B participates in a nonqualified deferred compensation plan providing for a lump sum payment payable on or before the 90th day immediately following the date upon which Employee B separates from service. Employer Y retains the sole discretion to determine when during the 90-day period the payment will be made. Although the plan does not specify a period during one calendar year in which the payment will be made, the plan provides for a payment upon a separation from service in compliance with this section because the period over which the payment may be made is not longer than 90 days.

"A right to a tax gross-up payment is a right to deferred compensation . . .."

Example 3. **(Payment Within 180 Days Following Separation)** Employee C provides services as an employee of Employer X, but is not a specified employee. Employee C participates in a nonqualified deferred compensation plan providing for a lump sum payment payable on or before the 180th day following the date upon which Employee C separates from service. Employer X retains the sole discretion to determine when during the 180-day period the payment will be made. Because the plan does not specify a period during one calendar year in which the payment will be made, and because the period over which the payment may be made is longer than 90 days, the plan does not provide for a payment upon a separation from service that complies with this section.

Example 4. **(Individual Limit)**. Employee D provides services as an employee of Employer W, but is not a specified employee. Employee D participates in a nonqualified deferred compensation plan providing for 10 installment payments payable on the first 10 anniversaries of the date Employee D separates from service, provided that no installment payment in any year may be more than 1% of Employer W's net income for the previous calendar year, and provided further that the excess over such limit that would otherwise be payable but is not paid due to application of the limit will become payable as of the first installment payment date at which time such amount, in combination with any installment payment otherwise due Employee D, does not exceed 1% of Employer W's net income for the previous calendar year. Provided that Employee D does not retain effective control of the calculation of Employer W's net income or the amount that Employee D will not be paid due to application of the limit, the plan provides for a schedule of payments upon a separation from service that complies with this section.

Example 5. **(Aggregate Limit)** Employee E and Employee F provide services as employees of Employer V, but neither is a specified employee. Employee E and Employee F both participate in substantially identical nonqualified deferred compensation plans providing for 10 installment payment payable on the first 10 anniversaries of the date the respective employee separates from service, provided that the total amount of installment payments in any year may not be more than 1% of Employer V's net income for the previous year, that where any payments are not made due to application of the limit the determination of the amount not paid to a particular employee will be made by applying the overall limit proportionately based upon the installment payment due the employee that year, and that the excess over such limit that would otherwise be payable but is not paid due to application of the limit will become payable as of the first installment payment date at which time such amount, in combination with any installment payments otherwise due the participants, does not exceed 1% of Employer V's net income for the previous calendar year. Provided that neither Employee E nor Employee F retains effective control of the calculation of Employer V's net income or the amount that the respective employee will not be paid due to application of the limit, the plan provides for a schedule of payments upon a separation from service that complies with this section.

Example 6. **(Payment Upon Receipt by Employer)** Employee G provides services as an employee of Employer U, but is not a specified employee. As a bona fide part of this employment relationship, Employee G provides professional services to clients of Employer U as part of the bona fide, ordinary course of Employer U's trade or business. Under an arrangement between Employee G and Employer U, Employer U agrees to pay Employee G upon Employee G's separation from service an amount equal to 5% of any amount collected from Company T, a client of Employer U for which Employee G performed services during his employment with Employer U, during the 36 months following Employee G's separation from service. Under the arrangement, the amounts due to Employee G based upon payments received by Employer U during any calendar year are payable to Employee G on April 1 of the subsequent calendar year. Provided that Employee G does not have effective control of Employer U, Company T, or the collection of any amounts due Employer Y from Company T, the arrangement

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provides for a schedule of payments upon a separation from service that complies with this section.

Example 7. **(Country Club Dues – Annual Limit)** Employee H provides services as an employee of Employer S, but is not a specified employee. Under a plan sponsored by Employer S, Employee H has a legally binding right upon a separation from service to the reimbursement of country club dues paid in the calendar year of the separation from service and each of the next 3 calendar years following the separation from service in an amount not to exceed $30,000 in any calendar year, provided that the amount of dues paid in any calendar year that are eligible for reimbursement equals only the amount actually expended during such calendar year, and the maximum amount available for reimbursement in any calendar year will not be increased or decreased to reflect the amount expended or reimbursed in a prior or subsequent calendar year. The plan further provides that any reimbursement must be paid to Employee H by December 31 of the calendar year following the year in which Employee H pays the country club dues. The reimbursement plan provides for a schedule of payments upon a separation from service that complies with this section.

Example 8. **(Country Club Dues – Aggregate Three Year Limit)** Employee J provides services as an employee of Employer Q, but is not a specified employee. Under a plan sponsored by Employer Q, Employee J has a legally binding right upon a separation from service to the reimbursement of country club dues paid during the calendar year in which the separation from service occurs and the next 3 calendar years in a total amount not to exceed $90,000. The plan further provides that any reimbursement must be paid to Employee J by December 31 of the calendar year following the year in which Employee J pays the country club dues. Because the reimbursement of a payment of country club dues in one calendar year may affect the amount of country club dues available for reimbursement in another calendar year, the plan does not provide for a schedule of payments upon a separation from service that complies with this section.

Substitutions. Generally, the payment of an amount as a substitute for a payment of deferred compensation is treated as a payment of the deferred compensation. In addition, where an employee's right to deferred compensation is made subject to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, or garnishment by creditors of the employee or the employee's beneficiary, the deferred compensation is treated as having been paid. Although forfeiture or voluntary relinquishment of an amount is not treated as a payment of the compensation, there is no forfeiture or voluntary relinquishment for this purpose if an amount is paid, or a legally binding right to a payment is created, that acts as a substitute for the forfeited or voluntarily relinquished amount.

Whether a payment or right to payment acts as a substitute for a payment of deferred compensation is determined based on all the facts and circumstances. Where, however, the payment of an amount results in an actual or potential reduction of, or current or future offset to, an amount of deferred compensation, the payment is a substitute for the deferred compensation. Similarly, if an employee receives a loan the repayment of which is secured by or may be accomplished through an offset of or a reduction in the amount deferred, the loan is a substitute for the deferred compensation.

Even where there is no explicit reduction or offset, the payment of an amount or creation of new right to a payment proximate to the purported forfeiture or voluntary relinquishment of a right to deferred compensation is presumed to be a substitute for the deferred compensation. This presumption is rebuttable by a showing that the compensation paid would have been received regardless of the forfeiture or voluntary relinquishment. Factors indicating that a payment would have been received regardless of the forfeiture or voluntary

"[T]he payment of an amount . . . proximate to [a] purported forfeiture . . . of . . . deferred compensation is presumed to be a substitute for the deferred compensation."

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relinquishment include that the amount paid is materially less than the forfeited or relinquished amount, or consists of a type of payment customarily made in the ordinary course of business of the employer to employees who did not forfeit or relinquish deferred compensation (for example, a payment of accrued but unused leave or a payment for a release of actual or potential claims).

Delay in Payment by Employer. The regulations offer employers a limited ability to delay payments due under a nonqualified deferred compensation plan, without violating the requirements of Section 409A. In particular, the regulations provide generally that in the case of (a) payments the deduction for which would be limited or eliminated by the $1 million limitation of Tax Code Section 162(m), or (b) payments that would violate securities or other laws, the plan may provide that payment will be delayed. A plan may be amended to add a provision providing for such a delay, but the amendment cannot be effective for a period of at least 12 months. If a plan were amended to remove such a provision with respect to amounts previously deferred, the amendment would constitute a prohibited acceleration of payment. Where any scheduled payment to a specific employee in the employer's taxable year is delayed as a result of these rules, the delay in payment will be treated as a subsequent deferral election unless all scheduled payments to the employee that could be delayed in accordance with these rules are also delayed. Where payment is delayed to a date on or after the employee's separation from service, the payment will be considered to be a payment upon a separation from service for purposes of the six month delay required for specified employees.

"The regulations offer employers a limited ability to delay payments . . . without violating the requirements of Section 409A."

In the case of amounts for which a deduction would be limited or reduced by application of the $1 million limitation of Section 162(m), payment must be made either (a) in the first year in which the employer reasonably anticipates (or should reasonably anticipate) that Section 162(m) will not bar deduction of the payment, or (b) during the period beginning with the date the employee separates from service and ending on the last day of the calendar year in which the employee separates from service or the 15th day of the third month following the separation from service. In the case of a specified employee, the date that is six months after the employee's separation from service is substituted for the date of separation from service for purposes of the deadline for making payment just described. With respect to amounts that would result in a violation of federal securities laws or other applicable laws, payment must be made at the earliest date at which the employer reasonably anticipates the payment would not result in a violation of federal securities laws or other applicable laws.

Disputed Payments and Refusals to Pay. The regulations address whether an employer's refusal to pay deferred compensation when due will result in a 409A violation. This refusal could occur either where the employer disputes the amount of the payment or simply refuses to pay. In either situation, the regulations generally provide that the payment will be deemed to be made on the date scheduled, if (a) the employee accepts the portion (if any) of the payment the employer is willing to make (unless that acceptance will result in a relinquishment of the employee's claim to all or part of the remaining amount), and (b) makes prompt and reasonable, good faith efforts to collect the remaining amount. Any further payment (including payment of a lesser amount that satisfies the obligation to make payment) must be made no later than the end of the first calendar year in which the employer and the employee enter into a legally binding settlement of the dispute, the employer concedes the amount is payable, or the employer is required to make the payment pursuant to a final and nonappealable judgment or other binding decision. This rule is intended to address not only intentional refusals to pay, but also inadvertent delays (but, in either case, only if there is no collusion between the employee and employer).

For example, where through oversight an employer fails to make a payment on the required payment date, the payment will be treated as made on

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"In general, payments of deferred compensation may not be accelerated."

the specified date if the employee makes reasonable, good faith efforts to collect the payment, generally by providing timely notice to the employer that the payment is due and unpaid. For this purpose, efforts to collect the payment will be presumed not to be reasonable, good faith efforts unless (a) notice is given to the employer within 90 days of the latest date upon which the payment could have been timely made in accordance with the terms of the plan (and IRS regulations), and (b) if not paid, further measures to enforce the payment are taken within 180 days after that date. An employer will not be treated as having failed to make a payment where, pursuant to the terms of the plan, the employee is required to request payment, or otherwise provide information or take any other action, and the employee has failed to do so. An employee will be treated as having requested that a payment not be made, rather than the employer having refused to make payment, where the employer's decision not to make payment is made by the employee, or by any person or group of persons under the supervision of the employee at the time the decision is made.

Acceleration. In general, payments of deferred compensation may not be accelerated. IRS regulations do, however, list certain permissible payment accelerations, including:

1. payments necessary to comply with a domestic relations order,
2. payments necessary to comply with certain conflict of interest rules,
3. payments intended to pay employment taxes,
4. certain cash-out of small amounts related to termination of a participant's interest in the plan (where the amount does not exceed the Tax Code Section 402(g)(1)(B) limit, which is $15,500 for 2007),
5. payments intended to pay taxes on account of the failure to meet the requirements of Section 409A,
6. cancellation of deferrals following an unforeseeable emergency or 401(k) plan hardship distribution,
7. in the case of a 457(f) plan, payments intended to pay taxes upon a vesting event,
8. plan terminations and liquidations (as more fully discussed below),
9. certain distributions to avoid a nonallocation year for ESOPs under Tax Code Section 409(p),
10. distributions to pay state, local, or foreign tax obligations arising from participation in the plan,
11. cancellation of deferral elections due to disability (with the cancellation occurring by the later of the end of the calendar year in which the disability is incurred, or the 15th day of the third month following the date the disability is incurred, and where "disability" refers to a medically determinable physical or mental impairment resulting in the employee's inability to perform the duties of his or her position or any substantially similar position, where that disability can be expected to result in death or can be expected to last for a continuous period of not less than six months),

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"[T]he addition of a permissible payment event . . . results in an acceleration if the addition . . . could result in the payment being made at an earlier date . . .."

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12. offsets to satisfy certain debts of an employee to an employer, where the amount of the reduction in any calendar year does not exceed $5,000, and

13. payments as part of a settlement between the employee and employer of an arms-length bona fide dispute as to the employee's right to the deferred amount.

With respect to these exceptions from the prohibition on acceleration, a plan may either provide for acceleration of a payment in accordance with these rules, or may provide the employer with discretion to accelerate payments in accordance with the rules. A plan may not, however, provide an employee discretion with respect to whether a payment will be accelerated, and an employer may not provide an employee a direct or indirect election as to whether the employer's discretion to accelerate a payment will be exercised. Generally, a plan need not set forth in writing these exceptions from the acceleration prohibition, and the making of such an accelerated payment or addition of a plan term permitting the making of such a payment generally will not constitute the acceleration of a payment. The failure to make a payment that could be accelerated under these rules, or the deletion or modification of a plan term permitting the making of such a payment, will not be subject to the rules regarding a change in the time and form of payment (the subsequent deferral rules).

Acceleration Upon Intervening Event. An impermissible acceleration does not occur if payment is made in accordance with plan provisions, or an election as to the time and form of payment in effect at the time of initial deferral (or added in accordance with the rules on subsequent deferral elections), pursuant to which payment is required to be made on an accelerated schedule as a result of an intervening event, where that event is the employee's separation from service, disability, death, change of control, or unforeseeable emergency. For example, a plan may provide that a participant will receive six installment payments commencing at separation from service, and also provide that if a participant dies after those payments commence but before all payments have been made, all remaining amounts will be paid in a lump sum payment.

Accelerating Vesting. It is not a prohibited acceleration if an employer waives or accelerates the satisfaction of a condition constituting a substantial risk of forfeiture, provided that the requirements of Section 409A (including the requirements that payment be made upon a permissible payment event) are otherwise satisfied. For example, if a plan provides for a lump sum payment of a vested benefit upon separation from service, and the benefit vests under the plan only after 10 years of service, it is not a violation of 409A if the employer reduces the vesting requirement to five years of service, even if the service provider becomes vested as a result and receives a payment in connection with a separation from service before the employee would have completed 10 years of service. However, if the plan had provided for a payment at a fixed date, rather than at separation from service, the date of payment could not be accelerated due to the accelerated vesting.

Application of Acceleration Rules to Multiple Payment Events. Generally, the addition of a permissible payment event, the deletion of a permissible payment event, or the substitution of one permissible payment event for another, results in an acceleration if the addition, deletion, or substitution could result in the payment being made at an earlier date than the payment would have been made absent the addition, deletion, or substitution. However, the addition of death, disability, or an unforeseeable emergency as a potentially earlier alternative payment event to an amount previously deferred will not be treated as resulting in an acceleration of a payment, even if that addition results in the payment being paid at an earlier time than the payment would have been

"A plan can be terminated and liquidated [in certain circumstances], with distribution accelerated . . .."

made absent the addition of the payment event. Note, however, that the addition of such a payment event as a potentially *later* alternative payment event generally is subject to the rules governing changes in the time and form of payment.

Acceleration: Beneficiaries. An election to change the identity of a beneficiary does not constitute an acceleration of a payment merely because the election changes the identity of the recipient of the payment, if the time and form of the payment is not otherwise changed. In addition, an election before the commencement of a life annuity to change the identity of a beneficiary does not constitute an acceleration of a payment if the change in the time of payments (a) stems solely from a different life expectancy of the new beneficiary, such as in the case of a joint and survivor annuity, and (b) does not change the commencement date of the life annuity.

Plan Termination. The regulations provide limited, though welcome, relief from the rules governing the time and form of payments where a nonqualified deferred compensation arrangement is terminated. A plan can be terminated and liquidated, with distribution accelerated, if (a) the termination and liquidation does not occur proximate to a downturn in the financial health of the employer, (b) all arrangements of the same type (under the plan aggregation rules) are terminated with respect to all participants, (c) 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, (d) all payments are made within 24 months of termination of the arrangement, and (e) the employer does not adopt a new arrangement that would be aggregated with any terminated arrangement for a period of three years following termination.

Under a second plan termination exception, a corporate employer may, during the 30 days preceding or 12 months following a change in control of the corporation, elect to terminate and liquidate a plan (and all plans of the same type under the plan aggregation rules). All employees who are participants in the plan or other plans of the same type (under the plan aggregation rules) must receive all amounts deferred under those plans within 12 months of the date the employer takes irrevocable action to terminate and liquidate the arrangements. The relevant entities comprising the employer for this purpose are determined immediately following the change of control. This rule permitting plan termination and distribution applies only with respect to employees for whom a change in control has occurred. For example, where a change in control consists of a sale of a subsidiary corporation, such that the subsidiary corporation is no longer treated as a single employer with the (former) parent corporation, the requirement to terminate and liquidate substantially similar arrangements applies only to the purchaser employer group of corporations that now owns the subsidiary corporation. In addition, the rule would apply only to those employees who had experienced a change in control, generally consisting only of employees of the subsidiary corporation. Where the change in control consists of an asset purchase, the applicable employer with discretion to terminate and liquidate the plan is deemed to be the entity retaining the deferred compensation liability after the transaction.

Under a third exception, a plan may provide for the acceleration of distribution pursuant to termination of the plan upon a corporate dissolution taxed under Section 331 of the Tax Code or with the approval of a bankruptcy court. The amounts deferred must, however, be included in participants' gross income by the latest of (a) the calendar year in which the plan termination occurs, (b) the calendar year in which the amounts are no longer subject to a substantial risk of forfeiture, or (c) the first calendar year in which the payments are administratively practicable.

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

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

- The plan requires that the election not take effect until at least 12 months after the date on which the election is made
- In the case of an election related to a payment other than a payment on account of death, disability, or the occurrence of an unforeseeable emergency, the plan must require that the first payment with respect to which the election is made be deferred for a period of at least five years from the date the payment would otherwise have been made (the "five-year rule"), and
- The plan requires that any election related to a payment at a specified time or pursuant to a fixed schedule be made at least 12 months prior to the date of the first scheduled payment.

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

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

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

"The regulations . . . treat actuarially equivalent life annuities as one form of payment, thereby allowing elections to be made among those annuity forms at any time before the initial annuity payment . . .."

actuarially equivalent life annuities as one form of payment, thereby allowing elections to be made among those annuity forms at any time before the initial annuity payment, without regard to the rules on subsequent deferral elections.

Certain features are ignored for purposes of determining whether a particular annuity is treated as a life annuity for purposes of the form of payment rules (but not for purposes of determining whether a life annuity with such a feature is actuarially equivalent to a life annuity without such a feature). The specified features include: (1) term certain features (under which annuity payments continue for the longer of the life of the annuitant or a fixed period of time); (2) pop-up provisions (under which payments increase upon the death of the beneficiary or another event that eliminates the right to a survivor annuity); (3) cash refund features (under which payment is provided upon the death of the last annuitant in an amount that is not greater than the excess of the present value of the annuity at the annuity starting date over the total payments before the death of the last annuitant); (4) Social Security or railroad retirement leveling features (including leveling features related to early retirement, survivor or disability benefits); and (5) features applying a permissible cost-of-living index. Accordingly, a life annuity with any of these specified features may be treated as a life annuity without regard to the fact that the features cause the annuity to fail to satisfy the general definition of a life annuity, for example because the periodic payments are not substantially equal. However, a life annuity with such a feature may only be treated as the same form of payment as a life annuity without such a feature if the two life annuities are actuarially equivalent (taking into account the feature) and have the same initial payment date.

For purposes of the definition of a time and form of payment, a subsidized joint and survivor annuity is treated as actuarially equivalent to a single life annuity, provided that neither the annual lifetime annuity benefit nor the annual survivor benefit available under the joint and survivor annuity is greater than the annual lifetime annuity benefit available under the single life annuity. For example, a single life annuity providing $100 a month for the lifetime of the service provider may be treated as actuarially equivalent to a joint and survivor annuity providing up to $100 a month for the lifetime of the employee and up to $100 a month to the surviving joint annuitant.

The same actuarial assumptions and methods must be used in valuing each life annuity. This requirement applies over the entire term of an employee's participation in a plan, such that annuities must be actuarially equivalent at all times for the annuity options to be treated as one time and form of payment. However, provided the actuarial methods and assumptions are reasonable, there is no requirement that consistent actuarial assumptions and methods be used over the term of an employee's participation in a plan. Accordingly, a plan may change the actuarial assumptions and methods used to determine life annuity payments, provided that all of the actuarial assumptions and methods are reasonable. In addition, there is no requirement that the actuarial assumptions and methods used under a plan be the same as those used in a qualified plan sponsored by the employer.

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

Where there are multiple potential payment events, and possibly multiple forms of payment, the regulations apply the subsequent deferral rules for changing the time and form of payment (and the anti-acceleration rules) to each

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

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

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

The anti-acceleration provisions (rather than the subsequent deferral rules) apply where a payment event is removed from a plan that requires payment upon the latest of two or more payment events. The provisions governing subsequent deferral elections apply to the substitution of one payment event for another. As a result, the substitution of a change in control payment event for a separation from service event would only be permissible if the change were not effective for one year, and if the payment would occur only upon the later of a change in control event or five years following a separation from service.

The addition of death, disability, or an unforeseeable emergency as a potentially earlier payment event is a permissible acceleration. In contrast, the addition of death, disability, or an unforeseeable emergency as a potentially *later* payment event, such as through the addition of death as a payment event to a plan providing for a payment of deferred compensation on a fixed date (so payment would be due on the later of the fixed date or death) would be subject to the subsequent deferral election rules. Similarly, a plan amendment substituting an employee's death as a new payment event, in place of a fixed payment date, would be subject to the subsequent deferral rules. The substitution of death as a payment event will not cause the plan to be treated as a death benefit plan not subject to Section 409A. In contrast, the substitution or addition of a payment event other than death in a death benefit plan may, however, result in that plan being treated as providing for deferred compensation, and thereby becoming subject to the 409A rules.

The rules governing changes in the time and form of payment do not apply to changes in the time and form of payment under the terms of a domestic relation order, to the extent the change in time and form applies to a payment to be made to an alternate payee and not the employee. Accordingly, a domestic relations order generally may provide for a new time and form of payment to a spouse or former spouse of an employee, or provide a spouse or former spouse the discretion to determine the time and form of payment to him or her.

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Examples: Deferral Election Rules, Including Subsequent Deferral Elections

Example 1. **(Initial Election to Defer Salary)** Employer ZZ sponsors a plan under which Employee A may elect to defer a percentage of Employee A's salary. Employee A has participated in the plan in prior years. To satisfy the requirements of this section with respect to salary earned in calendar year 2008, if Employee A elects to defer any amount of such salary, the deferral election (including an election as to the time and form of payment) must be made no later than December 31, 2007.

Example 2. **(Designation of Time and Form of Payment Where an Initial Deferral Election is Not Provided)** Employer YY has a taxable year ending September 30. On July 1, 2008, Employer YY enters into a legally binding obligation to pay Employee B a $10,000 bonus. The amount is not subject to a substantial risk of forfeiture and does not qualify as performance-based compensation as described in §1.409A-1(e). Employer YY does not provide Employee B an election as to the time and form of payment. Unless the amount is to be paid in accordance with the short-term deferral rule of §1.409A-1(b)(4), Employer YY must specify the time and form of payment on or before July 1, 2008, to satisfy the requirements of this section.

Example 3. **(Initial Election to Defer Bonus Payable Based on Services During Calendar Year)** Employer XX has a taxable year ending September 30. Employee C participates in a bonus plan under which Employee C is entitled to a bonus for services performed during the calendar year that, absent an election by Employee C, will be paid on March 15 of the following year. The amount is not subject to a substantial risk of forfeiture and does not qualify as performance-based compensation as described in §1.409A-1(e). If Employee C elects to defer the payment of the bonus with respect to services rendered during calendar year 2008, Employee C must elect the time and form of payment not later than December 31, 2007, to satisfy the requirements of this section.

Example 4. **(Initial Election to Defer Bonus Payable Based on Services During Fiscal Year Other Than Calendar Year)** Employer WW has a taxable year ending September 30. Employee D participates in a bonus plan under which Employee D is entitled to a bonus for services performed during Employer WW's fiscal year that, absent an election by Employee D, will be paid on December 15 of the calendar year in which the fiscal year ends. The amount is not subject to a substantial risk of forfeiture and does not qualify as performance-based compensation as described in §1.409A-1(e). The amount qualifies as fiscal year compensation. If Employee D elects to defer the payment of the amount related to the fiscal year ending September 30, 2009, to satisfy the requirements of this section Employee D must elect the time and form of payment not later than September 30, 2008.

Example 5. **(Initial Election to Defer Bonus Payable Only if Service Provider Completes at Least 12 Months of Services After the Election)** Employer VV has a calendar year taxable year. On March 1, 2008, Employer VV grants Employee E a $10,000 bonus, payable on March 1, 2010 (with reasonable interest), provided that Employee E continues performing services as an employee of Employer VV through March 1, 2010. The amount does not qualify as performance-based compensation as described in §1.409A-1(e), and Employee E already participates in another account balance nonqualified deferred compensation plan. Employee E may make an initial deferral election on or before March 31, 2008 (within 30 days after obtaining a legally binding right), because at least 12 months of additional services are required after the date of election for the risk of forfeiture to lapse.

Example 6. **(Initial Election to Defer Bonus that Would Otherwise Constitute a Short-Term Deferral)** The same facts as Example 5, except that Employee E does not make an initial deferral election on or before March 31, 2008. Because the right to the compensation would not be treated as a deferral of compensation pursuant to §1.409A-1(b)(4) absent a deferral election (because the arrangement would be treated as a short-term deferral), Employee E may make an initial deferral election provided that the election may not become effective for 12 months and must defer the payment at least 5 years from March 1, 2010 (the first date the payment could become substantially vested). Accordingly, Employee E may make an election before March 1, 2009, provided that the election defers the payment to a date on or after March 1, 2015 (other than a payment due to death, disability, unforeseeable emergency, or a change in control event).

Example 7. **(Initial Election to Defer Sales Commissions)** Employer UU has a calendar year taxable year. As part of Employee F's services for Employer UU, Employee F sells refrigerators to customers unrelated to Employee F or Employer UU. Under the employment arrangement, Employee F is entitled to 10% of the sales price of any refrigerator Employee F sells, payable only upon the receipt of payment from the customer who purchased the refrigerator. For purposes of the initial deferral rule, Employee F is treated as performing the services related to each refrigerator sale in the calendar year in which each customer pays for the refrigerator.

Example 8. **(Initial Election to Defer Renewal Sales Commissions)** The same facts as Example 7, except that Employee F also sells warranties related to the refrigerators sold. Under the warranty arrangement, refrigerator warranty customers are entitled in a future year to extend the warranty for an additional cost to be paid at the time of the extension. Under Employee F's arrangement with Employer UU, Employee F is entitled to 10% of the amount paid for an extension of any warranty, payable upon the receipt of payment from the customer extending the warranty. For purposes of the initial deferral election rule, Employee F is treated as performing the services related to the amount paid for the extension of the warranty in the taxable year in which the customer pays for the warranty extension.

Example 9. **(Initial Election to Defer Investment Commissions)** Employer TT is in the trade or business of managing financial assets for customer accounts. Customers who deposit funds in an account with Employer TT are entitled to remove the account balance of such account upon 60 days notice to Employer TT. Employee G sells financial products and provides continuing customer service to certain unrelated customers involving the deposit and maintenance of funds in customer accounts managed by Employer TT. Under the employment arrangement, Employee G is entitled to a set percentage of the aggregate value of the assets held in the accounts of customers to whom Employee G sold financial products and provides customer service. Under the arrangement, the aggregate value of the assets held in the accounts is determined as of June 30 of each year, and unless Employee G elects to defer the payment, the amount is payable to Employee G in a lump sum on December 31 of the year in which the valuation is made. Employee G has no control over the valuation of the assets held in the accounts, or the calculation of the amount due Employee G. For purposes of the initial deferral rule, Employee G is treated as providing the services to which a payment relates during the July 1 through June 30 period ending on the June 30 date as of which the assets held in the account are valued.

Example 10. **(Initial Election to Defer Part-Year Compensation)** Employee H provides services as a teacher to Employer SS, a school system. The period of services routinely begins on the second Monday of August of one year and ends on the first Friday of June of the subsequent year. Employer SS provides an

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election to Employee H to receive the compensation for the period of services ratably over the period beginning on the second Monday of August of one year and ending on the last day of August of the subsequent year. Because the compensation constitutes recurring part-year compensation, as defined in paragraph (a)(14) of this section, and because the schedule will provide that all of the recurring part-year compensation is paid no later than September 30 of the subsequent year, Employee H will be deemed to have made a timely deferral election with respect to such recurring part-year compensation if Employee H elects before the first day of the service period to have the recurring part-year compensation paid under such schedule.

Example 11. **(Initial Election to Defer Negotiated Separation Pay)** Employer RR decides to terminate Employee J's employment involuntarily. As part of the process of terminating Employee J, Employer RR enters into bona fide, arm's length negotiations with respect to the terms of Employee J's termination of employment. As part of the process, Employer RR offers Employee J an amount that is in addition to any amounts to which Employee J is otherwise entitled, payable either as a lump sum payment at the end of 3 years or in 3 annual payments starting at the date of termination of employment. The election of the time and form of payment by Employee J may be made at any time before Employee J accepts the offer and obtains a legally binding right to the additional amount. The election may not apply to any amount to which Employee J already had a legally binding right.

Example 12. **(Election of Time and Form of Payments Under a Window Program)** Employer QQ establishes a window program, as defined in §1.409A-1(b)(9)(vi). Individuals who elect to terminate employment under the window program are entitled to receive an amount equal to 2 weeks pay multiplied by every year of service with Employer QQ. The individuals participating in the window program may elect to receive the payment as either a lump sum payment payable on the first day of the month after making the election to participate in the window program, or as a payment of 3 equal annual installments on each January 1 of the first 3 years following the election to participate in the window program. Employee K is eligible to participate in the window program. Employee K will be treated as making a timely deferral election if the election as to the time and form of payment is made on or before the date Employee K's election to participate in the window program becomes irrevocable.

Example 13. **(Initial Election to Defer Salary Earned During Final Payroll Period Beginning in One Calendar Year and Ending in the Subsequent Calendar Year)** Employer PP pays the salary of its employees, including Employee L, on a bi-weekly basis. One bi-weekly payroll period runs from December 24, 2008, through January 6, 2009, with a scheduled payment date of January 13, 2009. Employer PP sponsors, and Employee L participates in, a nonqualified deferred compensation plan under which Employee L may defer a specified percentage of his annual salary. The plan does not specify that any salary compensation paid for the payroll period in which falls January 1 is to be treated as compensation for services performed during the year preceding the year in which falls that January 1. For purposes of applying the initial deferral election rules, Employee L is deemed to have performed the services for the payroll period December 24, 2008, through January 6, 2009, during the calendar year 2009.

Example 14. **(Application of Deferral Election Rules and Anti-Acceleration Rules to a Nonqualified Deferred Compensation Plan Linked to a Qualified Plan)** Employee M participates in a qualified retirement plan that is a defined benefit plan that offers a subsidized early retirement benefit to employees who have attained age 55 and completed 30 years of service. Employee M, who has attained age 55 and completed 30 years of service, also participates in a nonqualified deferred compensation plan, under which the benefit payable is

"The addition of death, disability, or an unforeseeable emergency as a potentially earlier payment event is a permissible acceleration."

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calculated under a formula, with that benefit then reduced by any benefit that Employee M has accrued under the qualified retirement plan. In 2008, Employee M fails to elect the subsidized early retirement benefit under the qualified retirement plan, with the effect that the amounts payable under the nonqualified deferred compensation plan are increased by an amount equal to the reduction in the benefit payable under the qualified plan. In 2009, Employer NN amends the qualified retirement plan to increase benefits under the plan, resulting in a decrease in the amounts payable under the nonqualified deferred compensation plan equal to the increase in the benefit payable under the qualified plan. Neither of these actions constitutes a deferral election or an acceleration of a payment under the nonqualified deferred compensation plan.

Example 15. **(Subsequent Deferral Election)** Employee N participates in a nonqualified deferred compensation plan. Employee N elects to be paid in a lump sum payment at the earlier of age 65 or separation from service. Employee N anticipates that he will work after age 65, and wishes to defer payment to a later date. Provided that Employee N continues in employment and makes the election by his 64th birthday, Employee N may elect to receive a lump sum payment at the earlier of age 70 or separation from service.

Example 16. **(Subsequent Deferral Election Rule – Change in Form of Payment from Lump Sum Payment to Life Annuity)** Employee P participates in a nonqualified deferred compensation plan. Employee P elects to be paid in a lump sum payment at age 65. Employee P wishes to change the payment form to a life annuity. Provided that Employee P makes the election on or before his 64th birthday, Employee P may elect to receive a life annuity commencing at age 70.

Example 17. **(Subsequent Deferral Election Rule – Change in Form of Payment from Life Annuity to Lump Sum Payment)** Employee Q participates in a nonqualified deferred compensation plan. Employee Q elects to be paid in a life annuity at age 65. Employee Q wishes to change the payment form to a lump sum payment. Provided that Employee Q makes the election on or before his 64th birthday, Employee Q may elect to receive a lump sum payment at age 70.

Example 18. **(Subsequent Deferral Election Rule – Installment Payments Designated as Separate Payments)** Employee R, whose taxable year is the calendar year, participates in a nonqualified deferred compensation plan that provides for payment in a series of 5 equal annual amounts, each designated as a separate payment. The first payment is scheduled to be made on January 1, 2010. Provided that Employee R makes the election on or before January 1, 2009, Employee R may elect for the first payment scheduled to be made on January 1, 2010, to be made on January 1, 2015. If Employee R makes that election, but does not elect to defer the remaining payments, the remaining payments continue to be due upon January 1 of the 4 consecutive calendar years commencing on January 1, 2011.

Example 19. **(Subsequent Deferral Election Rule – Change in Form of Payment from Installment Payments Not Designated as Separate Payments to Lump Sum Payment)** Employee S participates in a nonqualified deferred compensation plan that provides for payment in a series of 5 equal annual amounts that are not designated as a series of 5 separate payments. The first amount is scheduled to be paid on January 1, 2010. Employee S wishes to receive the entire amount equal to the sum of all 5 of the amounts to be paid as a lump sum payment. Provided that Employee S makes the election on or before January 1, 2009, Employee S may elect to receive a lump sum payment on or after January 1, 2015.

Example 20. **(Subsequent Deferral Election Rule – Change in Form of Payment from Installment Payments Designated as Separate Payments to Lump Sum Payment)** Employee T participates in a nonqualified deferred compensation plan that provides for payment in a series of 5 equal annual

"The rules governing changes in the time and form of payment do not apply to changes in the time and form of payment under the terms of a domestic relation order . . .."

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amounts each of which is designated as a separate payment. The first amount is scheduled to be paid on January 1, 2010. Employee T wishes to receive the entire amount equal to the sum of all 5 of the amounts in a single lump sum payment. Provided that Employee T makes the election on or before January 1, 2009, Employee T may elect to receive a lump sum payment on or after January 1, 2019.

Example 21. **(Subsequent Deferral Election Rule – Change in Form of Payment from One Life Annuity Form to Another Life Annuity Form)** Employee U participates in a nonqualified deferred compensation plan that permits Employee U to elect before Employee U's separation from service whether to be paid in the form of a single life annuity beginning on the first day of the month following Employee U's separation from service, or an annuity beginning on the first day of the month following Employee U's separation from service under which annuity payments continue for Employee U's lifetime but not less than 10 years. The two types of annuities are actuarially equivalent at all times applying reasonable actuarial methods and assumptions. For purposes of this section, the two types of annuities are treated as a single form of payment. Accordingly, the election provided under the plan is not treated as providing a subsequent deferral election or accelerated payment, and an election by Employee U under the plan between the two annuity options made before the first scheduled payment date for an annuity payment is not treated as a subsequent deferral election or an acceleration of a payment.

Example 22. **(Subsequent Deferral Election Rule – Change in Time of Payment from Payment at Specified Age to Payment at Later of Specified Age or Separation from Service)** Employee V participates in a nonqualified deferred compensation plan that provides for a lump sum payment at age 65. Employee V wishes to modify the plan so that the deferred amount will be payable upon the later of Employee V's attainment of a specified age or separation from service. Provided that Employee V makes such election on or before his 64th birthday, Employee V may modify the plan so Employee V will receive a lump sum payment upon the later of age 70 or separation from service.

Example 23. **(Subsequent Deferral Election Rule – Change in Time of Payment from Payment at Separation from Service to Payment at Later of Separation from Service or Specified Age)** Employee W participates in a nonqualified deferred compensation plan that provides for a lump sum payment at separation from service. Employee W wishes to make the payment payable upon the later of separation from service or a predetermined age. Provided that Employee W makes such election on or before the date 1 year before a separation from service, Employee W may elect to receive a lump sum payment upon the later of the date 5 years following a separation from service or at a specified age.

Example 24. **(Subsequent Deferral Election Rule – Change in Time of Payment from Payment at Separation from Service to Payment at a Change in Control Event)** Employee X participates in a nonqualified deferred compensation plan that provides for a lump sum payment at separation from service. Employee X wishes to change the payment provision such that the payment is payable upon a change in control event. A change in the distribution provision to provide for a payment only upon a change in control event will violate the rules governing payment provisions, because the change could result in an acceleration if the change in control event occurs before Employee X separates from service, or a subsequent deferral if the change in control does not occur until after Employee X separates from service. However, provided that Employee X makes such election on or before the date 1 year before a separation from service, Employee X may elect to receive a payment upon the later of a change in control event or 5 years following a separation from service.

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

"The regulations . . . provide limited relief with respect to nonqualified plans linked to qualified retirement plans . . .."

Early comments from IRS and Treasury officials caused many to worry that 401(k) wrap plans could not operate consistent with the Section 409A rules. The regulations, however, make limited accommodation for these programs. Specifically, the regulations provide that a change in an employee's 401(k) deferral election which would affect the amount deferred under a wrap program will not be treated as either a deferral election or an acceleration of payment under the wrap plan. This means a change in an employee's 401(k) deferral election will not result in violation of the Section 409A rules with respect to the wrap plan. This relief applies, however, only if, for any given calendar year, the employee's action or inaction in making 401(k) elections does not cause the total amounts deferred under all nonqualified deferred compensation plans in which the employee participates to increase or decrease by an amount exceeding the Tax Code Section 402(g) limit ($15,500 in 2007, not counting catch-up contributions), plus the amount of any catch-up contributions the employee would be entitled to make ($5,000 in 2007).

Similar relief is provided with respect to matching contributions. In particular, an employee's election as to the amount he or she chooses to contribute as an elective deferral or after-tax contribution to a qualified plan that affects matching or other contingent contributions to be made under a nonqualified plan will not be treated as a deferral election or an acceleration. This relief applies, however, only if the total of the matching or contingent amounts does not exceed 100 percent of the matching or contingent amounts that would be provided under the qualified plan absent any plan-based restrictions reflecting Tax Code limits on qualified plan contributions.

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

With respect to these same nonqualified plans (that are linked to a qualified plan's benefit formula as described above), there will be no prohibited acceleration of payment, nor deferral of compensation, on account of the following actions or failures, even if the result is to decrease or increase amounts deferred under the nonqualified arrangement:

- The amendment of the qualified plan to increase or decrease benefits
- The cessation of future accruals under the qualified plan
- The addition, removal, increase, or reduction of a subsidized benefit or ancillary benefit under the qualified plan, or a

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participant's election whether to receive a subsidized benefit or ancillary benefit under the qualified plan.

This relief is, however, available only if the change in the amount deferred under the nonqualified plan does not exceed the change in the amounts deferred under the related qualified plan.

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

In a fashion akin to the rules applicable to nonqualified plans linked to qualified retirement plans, the regulations address changes in elections under cafeteria plans. In particular, a change in an election under a cafeteria plan will not constitute a deferral election under a nonqualified plan to the extent any change in the amount deferred under the nonqualified plan results solely from a change in eligible compensation. This relief applies only if the benefit formula under the nonqualified plan is based upon the employee's eligible compensation, and only to the extent the change in compensation applies in the same manner as would any other increase or decrease in compensation.

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

What Effective Date and Transition Rules Apply?

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

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

Calculation of Grandfathered Amounts. For account balance plans, the grandfathered amount not subject to Section 409A generally will be an employee's vested account balance as of December 31, 2004, plus any earnings with respect to those amounts. For equity-based compensation, the grandfathered amount generally will be the payment that would be available if the right were exercised on December 31, 2004, plus any earnings with respect to that amount. Earnings generally would include, for this purpose, any increase in the payment available due to appreciation in the underlying stock.

As to nonaccount balance plans, the grandfathered amount is the present value as of December 31, 2004, of the amount to which the employee would be

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

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

Material Modifications to Grandfathered Plan. Grandfathered plans will become subject to Section 409A upon any material modification, even if that modification occurs many years in the future. Generally, a modification is material if a benefit or right existing as of October 3, 2004, is materially enhanced or a new material benefit or right is added, and that material enhancement or addition affects amounts earned and vested before January 1, 2005. A material benefit enhancement or addition is a material modification whether it occurs pursuant to an amendment or instead through the employer's exercise of discretion under the terms of the plan. For example, an amendment to a plan to provide that payments of deferred amounts earned and vested before January 1, 2005, will be allowed upon request if the employee forfeits 20 percent of the amount of the payment (a haircut) will be a material modification to the plan. It is not, however, a material modification for an employer to exercise discretion over the time and manner of payment of a benefit to the extent that discretion is provided under the terms of the plan as of October 3, 2004. In addition, it is not a material modification for an employee to exercise a right permitted under the plan as in effect on October 3, 2004.

The amendment of a plan to bring the plan into compliance with Section 409A will not be treated as a material modification. However, a plan amendment or the exercise of discretion under the terms of the plan that materially enhances an existing benefit or right or adds a new material benefit or right will be considered a material modification even if the enhanced or added benefit would be permitted under Section 409A. For example, the addition of a right to a payment upon an unforeseeable emergency of an amount earned and vested before January 1, 2005, would be considered a material modification.

The reduction of an existing benefit is not a material modification. For example, the removal of a haircut provision generally would not constitute a material modification. In addition, the following modifications are not material modifications:

1. the establishment of, or contributions to, a trust or other arrangement from which benefits are to be paid, so long as the contribution to the trust or other arrangement would not otherwise cause an amount to be includible in the employee's gross income;

2. the modification of a provision requiring the immediate cancellation of a current deferral election, to require the cancellation of deferrals for the same length of time beginning with the first date at which the application of the cancellation would not violate Section 409A (for example, January 1 of the calendar year following the cancellation);

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3. compliance with a domestic relations order with respect to payments to an individual other than the employee, or an amendment to a plan to require compliance with a domestic relations order with respect to payments to an individual other than the employee;

4. the modification of a plan providing a life annuity form of payment to permit an election between the existing life annuity form of payment and other forms of annuity payments that would be treated as a single form of payment with the existing life annuity form of payment under the subsequent deferral rules described earlier in this newsletter; or

5. the modification of a grandfathered plan to add a limited cash-out feature consistent with the involuntary cash-out rule exception to the prohibition on acceleration of payments, as described earlier in this newsletter.

The grant of an additional benefit under an existing plan that consists of a deferral of additional compensation not otherwise provided under the plan as of October 3, 2004, will be treated as a material modification of the plan only as to the additional deferral of compensation, if the plan explicitly identifies the additional deferral of compensation and provides that the additional deferral of compensation is subject to Section 409A. Accordingly, amendments to conform a plan to the requirements of Section 409A with respect to deferrals under a plan occurring after December 31, 2004, will not constitute a material modification of the plan with respect to amounts deferred that are earned and vested on or before December 31, 2004, provided that there is no concurrent material modification with respect to the amount of, or rights to, amounts deferred that were earned and vested on or before December 31, 2004.

A cessation of deferrals under, or termination of, a plan, pursuant to the provisions of that plan, is not a material modification. Amending a plan to provide participants an election whether to terminate participation in a plan generally does, however, constitute a material modification.

The regulations provide some very limited relief to avoid an inadvertent loss of grandfathered status. In particular, to the extent a modification is rescinded before the earlier of (a) the date any additional right granted under the modification is exercised (if the change grants a discretionary right), or (b) the end of the calendar year in which the modification was made, the modification will not be treated as material. For example, if a subsequent deferral feature is added to a nonqualified plan that allows a participant to extend the time and form of payment of a grandfathered deferred amount, and if that right is removed before the earlier of the time the participant exercises the right or the end of the calendar year, the modification will not be treated as a material modification of the plan. This exception is not, however, intended to cover a material modification that is made with the knowledge that the modification will cause the plan to lose its grandfathered status, but is then rescinded.

Transition Relief. The IRS has offered various forms of transition relief for the periods 2005 through 2007. Some of that relief was available only during 2005, or during 2005 and 2006, and is therefore no longer available. Final IRS regulations become effective January 1, 2008. For periods prior to that date, a plan must follow a good faith, reasonable interpretation of the statute, and, to the extent not consistent therewith, the plan's terms.

Although the requirements of Section 409A are currently in effect, the deadline for amending plan documents to conform with those requirements and the regulations thereunder is December 31, 2007. The required plan

"Final IRS regulations become effective January 1, 2008."

amendments need only bring the document into compliance effective January 1, 2008. This means they are not required to reflect any amendments made or actions taken under the transition rules, to the extent those amendments or actions do not affect the plan's compliance with Section 409A for periods on or after January 1, 2008. For example, if a plan contains a haircut provision permitting an immediate distribution contingent on the forfeiture of a certain portion of a deferred amount, the haircut provision need not be removed retroactively for periods before January 1, 2008, where the plan has been operated in compliance with the applicable transition guidance (and thus no payment pursuant to the haircut provision has been made after December 31, 2004). In addition, a plan need not be amended to be made compliant with Section 409A with respect to amounts deferred under the plan that were paid on or before December 31, 2007, where those amounts were paid in compliance with the transition guidance. Taxpayers (such as employers and employees) must, however, be able to demonstrate that the plan was operated in compliance with the transition guidance. This includes a requirement that they be able to demonstrate that amounts were deferred or paid in compliance with the transition rules. For example, where payments were made in conjunction with elections of payment dates by either the employer or employee during the transition period, the taxpayer must be able to demonstrate that the elections were provided and made in accordance with the transition rules.

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

Changes in Payment Elections. With respect to amounts subject to Section 409A and amounts that would be treated as short-term deferrals (under the rules described earlier), a plan may be amended to permit a participant to make a new payment election, without violating the subsequent deferral and anti-acceleration rules, if the plan is amended to so provide and the participant makes his or her election on or before December 31, 2007. A participant may not, however, in 2007 change a payment election with respect to payments the participant would otherwise receive in 2007, or cause payments to be made in 2007 that would not otherwise be payable in 2007.

Payments Tied to Qualified Plan Distributions. As noted earlier, Section 409A does not permit the time and form of payment under a nonqualified deferred compensation plan to be controlled by the time and form of payment elected by an employee under a qualified retirement plan. Nevertheless, for periods ending on or before December 31, 2007, an election as to the timing and form of payment under a nonqualified plan that is controlled by a payment election made by an employee or beneficiary of the employee under a qualified plan will not be considered to violate Section 409A. This relief applies only if the determination of the timing and form of the payment is made in accordance with the terms of the nonqualified plan governing payment, as those terms were in effect as of October 3, 2004. So, if a nonqualified plan provides as of October 3,

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"Even though the plan amendment deadline is not until December 31, 2007, employers must be in good faith compliance with the new rules currently. . .."

2004, that the time and form of payment to an employee or beneficiary will be the same as the time and form of payment elected by the employee or beneficiary under a related qualified plan, it will not be a violation of Section 409A for the plan administrator to make or commence payments under the nonqualified plan on or after January 1, 2005, and on or before December 31, 2007, pursuant to the payment election made under the related qualified plan.

Conclusion. There will be much to do in coming months to bring nonqualified deferred compensation plans into compliance with the new and complex rules of Section 409A. Even though the plan amendment deadline is not until December 31, 2007, employers must be in good faith compliance with the new rules currently, and should be working assiduously toward adoption of 409A-compliant plan documents.

We have described here only a portion of the complex new requirements for deferred compensation. In doing so, we have simplified certain rules and failed to mention others. As a result, and because these materials provide information only of a general nature, it is important that you consult with legal counsel before taking action. In particular, it will be important to consider your organization's particular circumstances before making any decisions relating to your organization's plans. Those circumstances may affect the legal conclusions discussed in this newsletter, as well as the approach best suited for your organization.

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