



WHITE & CASE

An Analysis of the Final
409A Regulations on
Deferred Compensation

Executive Compensation,
Benefits and Employment Law

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An Analysis of the IRS's Section 409A Regulations on Deferred Compensation

In 2007, the US Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS") issued final regulations under Section 409A of the Internal Revenue Code of 1986 (the "Code"), the landmark provision that marked a major change in the tax treatment of certain deferred compensation plans. The final regulations together with additional subsequent authority, contain limited transition periods expiring at the end of 2008 and other guidance that will have an immediate impact on employers, from major corporations to small enterprises.

The final regulations, issued on April 10, 2007, provide definitive guidance on the taxation of nonqualified deferred compensation and amounts includible in income under Section 409A. Section 409A imposes significant restrictions on a wide variety of nonqualified deferred compensation plans and arrangements. If a nonqualified deferred compensation plan fails to meet the rules contained in the legislation and related IRS guidance, there are adverse tax consequences for the individual with respect to whom the failure relates. This article is an updated version of the article White & Case LLP released last year, discussing the proposed regulations under Section 409A. Subsequent to the issuance of the final regulations, the IRS issued Notice 2007-86, which extends the applicable period of much of the transition relief regarding Section 409A through 2008. White & Case personnel participated actively in the professional activities and meetings with Treasury and the IRS relating to the need for extended transition relief, ultimately leading to the issuance of Notice 2007-86. This article recommends actions for employers to take in 2008 and, in doing so, describes significant provisions of the final regulations and other relevant authority.

Summary of Section 409A

Section 409A provides that all amounts deferred under a nonqualified deferred compensation plan are included in income when deferred (or, if later when the amounts are no longer subject to a substantial risk of forfeiture) unless certain requirements established by Section 409A are satisfied. The requirements include rules regarding the timing of deferral and distribution elections and permissible distribution events. Generally, a distribution can be made upon an employee's separation from service, disability, death, a specified time, a change in ownership or effective control or in the ownership of a substantial portion of the assets, of a corporation (or partnership) or an unforeseeable emergency. If an amount of deferred compensation is required to be included in income under Section 409A, that amount is subject to ordinary income tax plus an additional 20 percent income tax and interest may be assessed on tax underpayments in certain circumstances.

Section 409A is applicable to (i) amounts deferred in taxable years beginning after December 31, 2004 and (ii) amounts deferred in taxable years beginning before January 1, 2005, if the plan under which the deferral is made was materially modified after October 3, 2004.

Under Notice 2007-86, a nonqualified deferred compensation plan subject to Section 409A will not be treated as violating Section 409A on or before December 31, 2008 if the plan is operated in compliance with Section 409A and any generally applicable guidance published with a pre-2008 effective date (other than the regulations), so long as the plan is amended before 2009 to conform to the provisions of Section 409A (including the regulations). Prior to 2009, to the extent an issue is not addressed in generally applicable guidance published with a pre-2008 effective date, the plan must be operated consistent with a good faith, reasonable interpretation of Section 409A and, to the extent not inconsistent therewith, the plan's terms.

For periods before January 1, 2008, compliance with the proposed regulations or the final regulations constitutes reasonable, good faith compliance with Section 409A and to the extent that any of the proposed regulations, the final regulations or Notice 2005-1 is inconsistent with each other, the plan may comply with any of them. For periods after December 31, 2007 and before January 1, 2009, compliance with the final regulations (but not the proposed regulations) will constitute reasonable, good faith compliance with Section 409A and to the extent the final regulations are inconsistent with Notice 2005-1, the plan may comply with the final regulations or Notice 2005-1 (but not the proposed regulations).

Employers should consider taking the following actions in 2008 in response to Section 409A and the final regulations.

Identify Plans Subject to Section 409A

Generally. Employers should determine, if they have not already done so, whether any of their plans or arrangements are nonqualified deferred compensation plans.¹ Section 409A applies to nonqualified deferred compensation plans, which are plans and arrangements that provide for the deferral of compensation, other than tax-qualified plans and plans that provide vacation leave, sick leave, compensatory time, disability pay or death benefits. A plan provides for deferral of an employee's compensation if, under the plan and the relevant facts and circumstances, the employee has a legally binding right during a taxable year to compensation that is or may be payable to the employee in a later taxable year.² An employee can have a legally binding right to compensation even if the compensation is not yet vested. An employee does not have a legally binding right if the employer has discretion to reduce or eliminate the compensation after the employee performs the related services, unless such discretion lacks substantive significance or can only be exercised upon a condition. For example, in the case of an employer who promises a bonus to an employee that may be reduced or eliminated at the unfettered discretion of the employer, provided that the employee is not related to and does not have control over, the individual with the power to exercise such discretion, that promise will generally not give the employee a legally binding right to the bonus. A legally binding right to an amount that will be excluded from income when received is not deferred compensation, unless such amount was or can be, exchanged for an amount that is includible in income.

The regulations also contain a general anti-abuse provision to address plans that contravene the purpose of Section 409A. Specifically, the regulations clarify that if the principal purpose of a plan is to achieve a result with respect to a deferral of compensation that is inconsistent with the purposes of Section 409A, the IRS may treat the plan as a nonqualified deferred compensation plan that is subject to Section 409A.

Service Providers. Though we use the terms "employee" and "employer" throughout this article for the sake of simplicity, Section 409A generally applies in respect of all service providers, including outside directors, independent contractors and personal service corporations and all recipients of their services. However, Section 409A does not apply to amounts deferred by independent contractors that provide significant services to two or more clients that are not related to each other or the independent contractor. The regulations provide a safe harbor under which, generally, a contractor is deemed to be providing significant services to two or more clients if the revenues generated from the services provided to any client do not exceed 70 percent of the total revenues generated by the contractor. Compensation arrangements between an independent contractor and a client that involve the provision of "management services" are not excluded from Section 409A. "Management services" are services involving actual or de facto direction or control of the financial or operational aspects of the client's trade or business or investment management or advisory services to a client whose primary trade or business includes the investment of financial assets (including investments in real estate), such as a hedge fund or real estate investment trust. Section 409A only applies to a service provider for any year in which the service provider accounts for gross income under the cash receipts and disbursements method of accounting (i.e., service providers who use the accrual method of accounting will generally not be subject to Section 409A). Therefore, deferred compensation arrangements between hedge funds and cash-method investment managers will be subject to Section 409A even if the manager provides services to two or more clients. See also "Have Deferral Elections Specify the Time and Form of Payment in Accordance with Section 409A—Back-to-Back Arrangements of Investment Managers" below.

Arrangements with One Person. Agreements and arrangements, including agreements or arrangements with one person, can be nonqualified deferred compensation plans under Section 409A. For example, a provision in an employment agreement that provides for the deferral of the employee's bonus is a "nonqualified deferred compensation plan." Likewise, a provision in an employment agreement that provides for severance may also be a "nonqualified deferred compensation plan." See also "Review Separation Pay Plans" below.

Short-Term Deferrals. Even if a plan falls within the general definition of a nonqualified deferred compensation plan, it may meet one of several specified exceptions that will bring the plan outside the scope of Section 409A. A deferral of compensation does not occur if the plan under which the payment is made does not provide for a deferred payment and the compensation is paid within two and a half months after the later of (i) the end of the employee's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture or (ii) the end of the employer's

¹ The regulations do not address in detail the specific application of Section 409A arrangements between partnerships and partners.

² Amounts that are actually or constructively received and included in gross income may still be deferred compensation. For example, if an employee has made an irrevocable election to defer a portion of his 2008 salary until 2010, the amount is treated as deferred compensation regardless of whether the employer actually pays such amount to the employee in 2008 (i.e., the payment of the salary in 2008 is an impermissible accelerated payment of deferred compensation, even though the employee receives and includes the salary in income in 2008).

first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture. The short-term deferral exception only applies to payments made under a plan with respect to any payment that is not a deferral payment. A payment is a deferred payment if it is made pursuant to a provision of a plan that provides that the payment will be made or completed upon any date or event that will or may occur after the two and a half-month period mentioned above. For example, if a plan provides that a payment will be made upon an event, such as a change-in-control or separation from service that may occur during or after the applicable two and a half-month short term deferral period the short-term deferral exception will not be available. If the taxpayer establishes that it was administratively impracticable (and that such impracticability was unforeseeable) or would have jeopardized the ability of the employer to continue as a going concern, to make a payment that would otherwise be a short-term deferral within the required time period, the payment will still qualify for the short-term deferral exception if it is paid as soon as administratively practicable or when the payment would not have that effect. Delays are also permitted to avoid the unanticipated application of Section 162(m) of the Code (the US\$1 million annual cap on deductible compensation for certain employees of publicly held corporations), provided that the payment must be made as soon as reasonably practicable following the date on which the employer reasonably anticipates that the deduction will not be restricted by Section 162(m). A plan does not need to specify a payment date in order to qualify for the short-term deferral exception. However, the rules regarding timely payments (e.g., the rule that permits an employer to make a payment any time in the year following a specified payment date) and the rules permitting the employer limited discretion to delay payments, each as described in “Have Deferral Elections Specify Time and Form of Payment in Accordance with Section 409A—Timely Payments and—Certain Permitted Delays in Payment” below, are only available if the plan specifies a payment date. As a result of these considerations, in most circumstances, employers will want to specify the date of payment in the plan.

Plan Aggregation. All plans in which an employee defers compensation that fall within the same category, as described below, are aggregated for certain purposes under Section 409A, including initial participation determinations, plan terminations and income inclusion upon a Section 409A violation. Specifically, a violation of Section 409A under one plan with respect to an employee will cause amounts deferred by the employee under all plans in the same category to be subject to income inclusion and penalty under Section 409A. The categories of plans that are aggregated for certain purposes under Section 409A are as follows: (i) account balance plans where the deferral is at the election of the employee, (ii) account balance plans where the deferral is not at the election of the employee, (iii) non-account balance plans, (iv) separation pay arrangements providing benefits under a “window program” or upon involuntary separation from service, (v) in-kind benefits or reimbursements of expenses that do not constitute a substantial portion of the employee’s compensation for services or separation, (vi) split-dollar life insurance arrangements, (vii) certain amounts deferred under foreign plans, (viii) stock rights and (ix) all other plans.

Split-Dollar Life Insurance Arrangements. Concurrent with the release of the regulations, the IRS released Notice 2007-34, which addresses the application of Section 409A to split-dollar life insurance arrangements and whether changes to such arrangements to comply with Section 409A may constitute a material modification that will cause the plan to lose grandfathered treatment under the IRS’s split-dollar regulations. Split-dollar life insurance arrangements that provide only death benefits to or for the benefit of an employee, are grandfathered under Section 409A (i.e., all benefits were vested before 2005) or meet the requirements of the short-term deferral exception, are excluded from Section 409A.³ Split-dollar life insurance arrangements that are treated as loan arrangements generally will not be subject to Section 409A, provided that the loan payments are not and are not anticipated to be, waived, cancelled or forgiven. However, policies structured under the “economic benefit” method, where the employer is the owner of the policy but where the employee obtains a legally binding right to compensation includible in income in a taxable year after the year in which a substantial risk of forfeiture (if any) lapses, may provide for a deferral of compensation. For example, where an employer enters into an “economic benefit” method split-dollar life insurance arrangement with respect to an employee and irrevocably promises to pay premiums in future years, the arrangement may provide for a deferral of compensation that is subject to Section 409A. Notice 2007-34 clarifies that an “economic benefit” method split-dollar life insurance arrangement that was entered into prior to September 18, 2003 may not be subject to Section 409A, provided that such arrangement otherwise qualifies for grandfathered treatment under the IRS’s split-dollar regulations. Generally, the split-dollar regulations apply to split-dollar life insurance arrangements that are entered into or materially modified, after September 17, 2003. Notice 2007-34 provides that the modifications to a split-dollar life insurance arrangement to bring the arrangement into compliance with or to avoid, Section 409A, will generally not be considered a material modification to the arrangement under the split-dollar regulations, as long as the modification does not materially enhance benefits under the arrangement. Employers should review their split-dollar life insurance arrangements to determine whether they are subject to

³ Notice 2007-34 provides guidance on the allocation of earnings under a split-dollar life insurance arrangement that provides some benefits that are subject to Section 409A and some benefits that are not subject to Section 409A. Any reasonable method of allocation is permissible, provided that policy costs and expenses are not disproportionately allocated to the benefits subject to Section 409A.

Section 409A and determine whether any changes are necessary to comply with Section 409A (and, if so, whether any such change may be a material modification of an arrangement that is otherwise grandfathered under the split-dollar life insurance regulations).

Identify Grandfathered Plans and Rescind Inadvertent Material Modifications

If one of an employer's plans is identified as a nonqualified deferred compensation plan, the employer should determine whether amounts deferred under the plan can be grandfathered (and whether the employer wants to continue the plan as a grandfathered plan). Generally, amounts deferred and vested in taxable years beginning before January 1, 2005 (as well as earnings on these amounts) are referred to as grandfathered amounts. If the plan is grandfathered (i.e., the plan relates solely to grandfathered amounts), it is not subject to Section 409A as long as the plan is not materially modified after October 3, 2004. A modification is a "material modification" if a benefit or right existing as of October 3, 2004 is materially enhanced or a new material benefit or right is added, even if the enhanced or added benefit is permitted under Section 409A. However, if a material modification to a plan is rescinded before the end of the taxable year of the employee in which it was adopted and before any additional right granted under the modification is exercised, the plan may still be considered a grandfathered plan. Any employer who inadvertently adopted an amendment in 2008 that materially modified a plan the employer otherwise intended to be grandfathered, should rescind the amendment as soon as possible but no later than December 31, 2008. Any material modification to a plan after October 3, 2004 but prior to 2008 cannot be rescinded and will result in a loss of the plan's grandfathered status.

The regulations clarify that certain amendments and modifications will not be material modifications to an otherwise grandfathered plan, including:

- A provision of a grandfathered plan requiring cancellation of deferrals for a prescribed period of time in order to receive a distribution from such plan may be modified to provide that deferral elections will be cancelled for the equivalent period of time beginning with the first date that such cancellation will not result in prohibited acceleration of payment (generally the beginning of the subsequent calendar year)⁴
- Modifications to comply with domestic relations orders
- Modifications to permit employees to elect between an existing life annuity and another actuarially equivalent annuity payment
- Modifications to required cashouts of account balances that are less than the limit in Section 402(g) of the Code (US\$15,500 in 2008)

Adopt Section 409A Plan Amendments, Put Plans in Writing and Operate in Compliance With Section 409A

All nonqualified deferred compensation plans that are not grandfathered should be amended to comply with Section 409A by December 31, 2008. Employers should begin to prepare amendments to ensure that their nonqualified deferred compensation plans, among other things, (i) set forth permissible timing requirements for deferral elections, (ii) set forth permissible requirements for subsequent elections to extend deferral periods or otherwise change payment elections, (iii) do not permit prohibited accelerations of payments (although the plan is not required to affirmatively set forth the permitted exceptions to the anti-acceleration rule), (iv) have plan definitions relating to the payment of nonqualified deferred compensation that conform to the definitions provided by Section 409A (e.g., the definitions of "disability," "unforeseeable emergency" and "change-in-control event") and (v) if applicable, set forth the required six-month delay in payment to specified employees. Importantly, the preamble to the regulations clarifies that the use of a "savings" clause (such as a clause which states "regardless of any inconsistent provision, this plan shall be interpreted in accordance with Section 409A"), will not be effective for purposes of Section 409A compliance.

⁴ Modifications of this kind may be necessary, for example, where an employee receives a distribution under a grandfathered plan that requires immediate cancellation of all deferrals for a period of one year in order to receive such distribution, but the employee has outstanding deferral elections under a plan subject to Section 409A (and cancellation of the deferral election would cause a violation of Section 409A). In such case, the grandfathered plan may be amended to provide that the cancellation of deferrals will be required for a period of one year beginning on the first day of the calendar year following the distribution.

A plan will violate Section 409A if it is not adopted and set forth in writing (i) before the end of the calendar year in which the employee obtains a legally binding right to compensation under the plan or (ii) within the first two and a half months of the year following the year in which the legally binding right arises provided that such compensation is not payable in such following year. The regulations clarify that the material terms of a plan may be set forth in more than one document. However, plans adopted before December 31, 2008, are not required to be in writing prior to December 31, 2008.

If a plan is a nonqualified deferred compensation plan and the plan is not grandfathered, the plan should be operated in compliance with Section 409A at all times prior to the date the plan is amended.

Permit Employees to Make Deferral Elections for Compensation Earned in 2009

General Rule. Elections to defer compensation to a later date must, generally, be made before the close of the tax year preceding the year during which the compensation is earned. Consequently, unless one of the exceptions described below applies, deferral elections in respect of compensation for services performed in 2009 should be made prior to December 31, 2008. It should be noted that the period of time during which compensation is earned may include periods arising prior to the grant of the legally binding right to such compensation (e.g., a discretionary bonus paid in January 2010 with respect to the employee's performance in 2009). A deferral election must include the time and form of payment and must be irrevocable as of the deadline for making such election. Thus, an evergreen deferral election that remains in effect from year to year will satisfy the statute's election requirements as long as such election becomes irrevocable on the date that an affirmative deferral election would otherwise have been required to be made. Unless one of the exceptions described below applies, evergreen elections in place for compensation for services performed in 2009 must become irrevocable on or prior to December 31, 2008.

No Ability of Employee to Elect. A plan that does not permit employees to elect the time and form of payments must specify the time and form of payment no later than the later of (i) the time the employee first has the legally binding right to the payment and (ii) the time the employee would have had to make an irrevocable deferral election, had such election been available to the employee. For example, in the case of an employer who, on December 15, 2008, grants an employee a bonus in respect of services to be performed in 2009 that may not be reduced or eliminated in the unfettered discretion of the employer and that is payable at a later date (but not at a time when such payment would qualify as a short-term deferral), the employer must establish the time and form of payment on or before December 31, 2008 (i.e., the date on which the employee could have made the election to defer the bonus).

Fiscal Year Compensation. If an employer has a taxable year other than a calendar year, a plan may provide that fiscal year compensation may be deferred at the employee's election if the election to defer such compensation is made not later than the close of the employer's taxable year immediately preceding the first taxable year in which any services are performed for which such compensation is payable. Fiscal year compensation is compensation relating to a period of service coextensive with one or more consecutive taxable years of the employer, of which no amount is paid or payable during the service period. For example, a bonus based on services performed during the employer's taxable year and paid after such taxable year would be fiscal year compensation, but a salary earned during such taxable year is not fiscal year compensation.

Unvested Compensation. With respect to compensation that is subject to forfeiture unless the employee continues to provide services for a period of at least 12 months from the date the employee obtains the legally binding right to such compensation, an election may be made on or before the 30th day after the employee obtains the legally binding right to the compensation, provided that the election is made at least 12 months in advance of the earliest date at which the forfeiture condition could lapse. The regulations clarify that this type of election is available even if the compensation may vest in less than 12 months due to the employee's death or disability or due to a change-in-control event (provided that if such an event occurs during the 12-month period, such deferral election will only be given effect if permitted by one of the other deferral election rules under Section 409A). This type of election is particularly useful for deferrals of restricted stock units, long-term bonuses and other types of awards that are granted in the middle of a taxable year. If an employee is granted such compensation in 2008, the employer should permit the employee to make any affirmative deferral election within 30 days after such grant.

Initial Participation. When an employee first becomes eligible to participate in a certain type of nonqualified deferred compensation plan (utilizing plan aggregation rules), a deferral election may be made within 30 days after the date the employee becomes eligible to participate in the plan, provided that the election only applies to compensation attributable to services performed after the election. For compensation that is based upon a specified performance period, if an initial participation deferral election is made after the beginning of the applicable performance period, the election must apply to a pro-rated portion of the compensation payable with respect to such performance period based on the amount of time remaining in the performance period after the election. The regulations clarify that this type of deferral election is available if the employee has not been an active participant in a plan (using the aggregation rules) for at least 24 months. Furthermore, the regulations provide that an employee is considered initially eligible to participate in a non-elective excess benefit plan on January 1 of the year following the first year in which the employee accrues a benefit under the plan. Employers should permit employees who first become eligible to participate in a certain type of nonqualified deferred compensation plan in 2008 to make a deferral election within 30 days after such employee begins participation in the plan. Note, that if an employee already participates in a certain type of plan of the employer, he or she is not considered newly eligible for purposes of this special election rule if he or she becomes eligible to participate in a different plan of the same type. For example, an employee who already participates in an elective account balance-type plan could not elect to defer a bonus for which he or she first becomes eligible during a calendar year under this new eligibility exception (however, the exception for unvested compensation described in the preceding paragraph may be available).

Performance-Based Compensation. In the case of performance-based compensation based on services performed over a period of at least 12 months, a deferral election may be made until six months before the end of the performance period, provided that the compensation is not readily ascertainable at that time. The definition of performance-based compensation is discussed further below in the section entitled "Identify Performance-Based Compensation and Prepare to Establish Performance Criteria" below.

Separation Pay Arrangements. In the case of amounts payable under a separation pay arrangement (i.e., an arrangement that provides for a deferral of compensation that will not be paid under any circumstances unless the employee has a separation from service) that is the product of a bona fide arm's-length negotiation at the time of an employee's separation from service, a deferral election may be made on or before the date the employee obtains a legally binding right to such amounts.

Amend Plans to Permit Employees to Make Certain Changes to Prior Elections

Transition Relief. On or prior to December 31, 2008, plans may be amended to allow employees to change the form and/or timing of payments, including elections that accelerate payments, without violating Section 409A. Employees may not, however, make elections in 2008 that would accelerate the payment of any amount into 2008 or defer the payment of any amount that would otherwise be paid in 2008 to a later year.

Redeferral Elections. Other than as described in the preceding paragraph, subsequent elections to further defer the distribution of deferred compensation are permissible under Section 409A only if the plan requires that: (i) the election not take effect until at least 12 months after the date on which the election is made, (ii) the election to further defer the distribution of deferred compensation (other than distributions following the employee's death or disability or on account of an unforeseeable emergency) must defer the distribution for at least five years from the date the deferred compensation would have been distributed to the employee had the employee not made a subsequent election and (iii) if the subsequent election relates to a distribution on a specified date or is to be paid in accordance with a fixed schedule, the subsequent election must be made at least 12 months before the date of the first scheduled payment. If compensation would otherwise meet the requirements of the short-term deferral exception, the date that the compensation vests will be treated as the initial payment date for purposes of any redeferral election. Accordingly, if an employee makes an affirmative deferral election after the beginning of the service period, the employee must make the election at least 12 months before the vesting date and must postpone the payment at least five years after the vesting date. If the payment actually vests within 12 months of the election, the election must be disregarded and payment must be made in accordance with the short-term deferral exception. Note that a series of installment payments is treated as a single payment (made on the first scheduled payment date) for purposes of these redeferral election rules and the prohibition on acceleration of payments, described below, unless the plan provides at all times that each installment will be treated as a separate payment. Plans may be modified prior to December 31, 2008 to elect to treat each installment as a separate payment.

Acceleration of Payments. With respect to elections made after December 31, 2008, Section 409A prohibits the acceleration of the time or schedule of deferred compensation payments, except in certain specified instances including (i) payments pursuant to a domestic relations order; (ii) payments as necessary due to certain conflicts of interest; (iii) certain limited cashouts (See “Limited Cashouts” below); (iv) payments to pay FICA taxes imposed on compensation deferred under the plan; (v) payments when the plan fails to meet the requirements of Section 409A; (v) cancellation of deferrals following an unforeseeable emergency, a hardship distribution under the employer’s 401(k) plan or the employee’s disability (utilizing a special definition of disability for this purpose); (vi) certain plan terminations (See “Terminate Plans Only in Accordance with Section 409A” below); and (vii) payments to reflect payment of state, local or foreign tax obligations arising from plan participation (and resulting US income tax withholding obligations). Elections to receive distributions subject to a “haircut” (i.e., a provision that would accelerate the timing of the payment of the deferred compensation, subject to the forfeiture of a portion of the amount that would otherwise have been paid to the employee) are not permitted by Section 409A. An acceleration of vesting (i.e., a waiver or acceleration of a substantial risk of forfeiture) of deferred compensation that is otherwise paid in compliance with the requirements of Section 409A does not violate this anti-acceleration rule. An election between actuarially equivalent life annuities is not a change in the time and form of payment. Note that the regulations do not permit the acceleration of deferred compensation payments to avoid a violation of the “top-hat plan” rules of the Employee Retirement Income Security Act of 1974, such as where a plan participant falls outside of a select group of management or highly compensated employees.

Limited Cashouts. The regulations provide that an employer may exercise discretion to cash out an employee’s entire deferred amount under a type of plan (using plan aggregation rules) any time that such amount is less than the limit in Section 402(g) of the Code for that calendar year (US\$15,500 in 2008). The regulations also provide that a plan under which amounts are to be paid in installments may provide for immediate and non-discretionary payment of all remaining installments if the present value of the deferred amount to be paid in the remaining installments is less than an amount pre-specified in the plan at the time of deferral.

Have Deferral Elections Specify the Time and Form of Payment in Accordance With Section 409A

Generally. Section 409A prohibits plans from permitting distributions of deferred compensation prior to the occurrence of one of the following: (i) the employee’s separation from service, (ii) the date the employee becomes disabled, (iii) the date the employee dies, (iv) a time or fixed schedule specified under the plan on the date of the deferral, (v) the date of a change in the ownership or effective control of a corporation or in the ownership of a substantial portion of its assets or (vi) the occurrence of an unforeseeable emergency. Plans that are subject to Section 409A should use or incorporate definitions of permissible payment events where such definitions control the timing of payment of deferred compensation. However, defined terms (e.g., disability and change in control event) that do not comply with the requirements of Section 409A may, in many cases, be used with respect to the vesting provisions applicable to deferred compensation.

Specified Time or Fixed Schedule. A plan may specify a payment to be made at a fixed time or on a fixed schedule by specifying the calendar year or years of payment that are non-discretionary and objectively determinable at the time the amount is deferred. A payment will be treated as being made at a fixed time or pursuant to a fixed schedule if it is triggered by a non-discretionary and objectively determinable vesting event (e.g., a payment that vests and is paid in three annual installments, following an initial public offering). The regulations provide guidance on the structure of permitted payment schedules. Payment schedules with fixed or objective formula limitations on the amount that will be paid during any particular period will meet the requirements of a fixed schedule, where the limitation is based on a fixed or nondiscretionary, objectively determinable formula limitation, where all of the factors relevant to the determination of such limit are beyond the control of the employer and not subject to any exercise of discretion by the employee. A formula may include a cap on each year’s distributions, either to an individual or to a group, provided that the plan includes a nondiscretionary, objectively determinable, method to allocate the required reductions and the plan specifies the time and form of payment of any amount that will be paid after its original due date due to the application of such cap.

Disability. For purposes of the Section 409A distribution rules, a disability is generally defined as the employee’s inability to engage in any substantial gainful activity or the receipt of benefits for at least three months under the employer’s disability plan as the result of the employee’s medically determinable physical or mental impairment that is expected to result in death or continue for at least 12 months.

Change-in-Control Event. The regulations set forth detailed definitions of a change-in-control event (i.e., a change in the ownership or effective control of a corporation and a change in the ownership of a substantial portion of the assets of a corporation). Until further guidance is issued, the rules regarding permissible distributions upon a change in ownership of a corporation or a change in the ownership of a substantial portion of the assets of a corporation could be applied by analogy to similar changes in ownership of a partnership. A change-in-control event occurs with respect to an employee only if the change relates to the corporation to which the employee provides services or the corporation that is liable for the payment of deferred compensation or any of their respective parent corporations (utilizing a 50 percent ownership test). Generally, a change-in-control event occurs, with respect to a corporation, upon (i) the acquisition by any person or group of more than 50 percent of the stock of the corporation, measured by voting power or value (other than acquisitions by a person or group that already owns more than 50 percent), (ii) the acquisition, over a 12-month period, by a person or group of 30 percent of the voting power of the corporation (reduced from 35 percent in the proposed regulations), (iii) a change in a majority of the members of the board of directors of the ultimate parent corporation over a 12-month period that is not approved by a majority of the members of the board or (iv) a sale of at least 40 percent of the corporation's assets over a 12-month period.

Unforeseeable Emergency. An unforeseeable emergency is defined as a severe financial hardship arising from illness or accident of the employee or the employee's spouse or dependents, loss of the employee's property due to casualty or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the employee. The need to pay medical expenses and prescription drug costs or the funeral expenses of a spouse, may also constitute an unforeseeable emergency. No distribution is permitted if the hardship may be relieved through reimbursement or compensation from insurance or by liquidation of the employee's assets (that would not cause a severe financial hardship) or by cessation of deferrals under the plan. Distributions are limited to the amount reasonably necessary to satisfy the emergency need (which may include taxes on the distribution).

Separation from Service. The regulations provide extensive guidance on when an employee (or a consultant) will be treated as having separated from service. An employee separates from service if the employee dies, retires or otherwise has a termination of employment with his or her employer. Whether an employee has experienced a termination of employment is determined based on whether the facts and circumstances indicate that the employer and the employee reasonably anticipated that no further services would be performed after a certain date or that the level of bona-fide services the employee would perform after that date would permanently decrease to no more than 20 percent of their average level in the preceding 36-month period. A separation from service is presumed to not occur in the event of a purported termination of employment if the employee continues to provide services to the employer (e.g., as a consultant) at a level that is 50 percent or more of the employee's average level of services for the preceding 36 months. Conversely, a separation from service is presumed to occur in the event of a purported continuation of employment of an employee, if the employee's services are reduced to a level that is 20 percent or less of the average level of the employee's services during the preceding 36 months. A leave of absence (other than due to disability) for more than six months is deemed to be a separation from service unless the employee has a right to reemployment. In applying the distribution rules for separation from service, all affiliates in the same controlled group are generally treated as a single employer (generally utilizing a 50 percent common ownership requirement, although the plan may specify an alternative common ownership requirement as low as 20 percent, if use of such requirement is based on legitimate business criteria or as high as 80 percent). In the event of a sale of all or substantially all of an employer's assets, the buyer and the seller may specify at the closing date whether transferring employees will be treated as having incurred a separation from service.

Required Six-Month Delay in Payments to Specified Employees. Deferred compensation payments upon the separation from service of a "specified employee" of a company that has publicly traded stock may not be made before the date that is six months after the date of separation from service. Whether the employer has publicly traded stock is determined as of the date of the specified employee's separation from service. The regulations provide a methodology for identifying specified employees (generally, any officer (but no more than 50 officers) with the highest annual compensation in excess of the limit used for determining key employees under Section 416 of the Code, which limit is US\$150,000 for 2008). Any individual who is a key employee of the employer during the 12-month period ending on an identification date chosen by the employer, will be a specified employee for purposes of Section 409A for a 12-month period beginning on an effective date selected by the employer that is not later than the first day of the fourth month after the identification date. If the plan does not designate an identification date, the identification date is December 31. If the plan does not designate an effective date, the effective date is the first day of the fourth month after the identification date. For example, if an employer has an identification date of December 31, 2008, then any employee who was a specified employee during calendar year 2008 will be subject to the six-month

delay on any payments that would otherwise be paid from April 1, 2009 to March 31, 2010. The regulations provide alternative methods for identifying employees subject to the six-month delay and implementing such delay. For example, plans may provide that payments to all employees will be delayed for six months following separation from service. A plan may also provide that the six-month delay will be applicable to an objectively determinable non-elective group of employees, designed to include all specified employees, provided that such group does not exceed 200 employees. The regulations require that the plan provide the manner in which this six-month delay will be implemented. A plan may provide that any payment to a specified employee pursuant to a separation from service that would otherwise be paid during the applicable six-month period, will be delayed until the end of the six-month period or that every payment that becomes payable to a specified employee pursuant to a separation from service will be delayed six months. A plan may be amended to change the manner in which the delay will be implemented, provided that the amendment is not effective for at least 12 months.⁵

Payment Upon Earlier or Later of Permissible Events. A payment of deferred compensation may be made upon the earlier or later of two or more permissible payment events and a different form of payment may be elected for each such payment event.

Designation of Payment Upon Permissible Event. A plan may provide that payment will be made on a date that is objectively determinable at the time of a permissible payment event (other than a specified time or fixed schedule), e.g., three months following disability. A plan may provide for a schedule of payments based on the date of such a permissible payment event (e.g., annual installments on the first three anniversaries of separation from service) if the schedule is fixed when the payment event is designated. A plan may also provide that payment will be made in an objectively determinable calendar year or years following the calendar year of such a permissible payment event, e.g., during the calendar year following the year of the employee's death. If no date within such a calendar year or years is specified, the payment date is deemed to be January 1 of such calendar year or years for purposes of applying the redeferral election rules described above in "Amend Plans to Permit Employees to Make Certain Changes to Prior Elections." It is not sufficient for a plan to state that a payment will be made "as soon as administratively practicable" after a payment event, unless the payment is restricted to a single tax year or no more than 90 days following the payment event (as long as the employee does not control the tax year of payment). Generally, only one time and form of payment is permitted with respect to each payment event. However, a plan may provide for a different time and form of payment depending upon whether a permissible payment event occurs on or before one specified date, e.g., payment of a lump sum on the first day of the month following separation from service before age 55, but five annual installments beginning on the first day of the month following separation from service on or after age 55. In the case of payments made upon an employee's separation from service, a plan may also permit alternative times and forms of payments depending on whether the employee's separation from service occurs (i) within two years of a change-in-control event and/or (ii) before or after a specified date or before or after a combination of a specified date and period of service (e.g., age plus years of service equals 65).

Timely Payments. A payment is treated as made upon the date specified under a plan if the payment is made on such date or any later date in the calendar year or, if later, by the 15th day of the third calendar month following the date specified in the plan and if the employee cannot control the year of payment. Amounts may be paid before a date specified under the plan if the payment is made no earlier than 30 days prior to the designated payment date and the employee does not designate the taxable year of payment. In the case of a payment on account of certain change-in-control events, compensation payable pursuant to the employer's purchase of stock or a stock right held by an employee or payment of amounts of deferred compensation calculated by reference to the value of employer stock, generally may be treated as complying with Section 409A if paid under the terms and conditions that govern the payments to shareholders or the employer in connection with the change-in-control event, to the extent that such payments are made no later than five years after such change-in-control event.⁶

Certain Permitted Delays in Payment. If the calculation of an amount is not administratively practicable due to events beyond the employee's control, or if making the payment would jeopardize the employer's ability to continue as a going concern, the payment will be treated as made on the date specified under the plan if the payment is made during the first calendar year in which the payment is administratively practicable or the making of the payment would not have that effect, as applicable. The regulations generally provide that a payment may be delayed that would otherwise (i) not be deductible under Section 162(m) of the Code or (ii) violate securities laws or other applicable laws. With respect to payments that are delayed due to

⁵ See also Andrew L. Oringer, "Terminating the Six-Month Delay on Severance Payments Under the Deferred Compensation," *Tax Notes*, July 2007.

⁶ This payment provision may be used to permit earn-outs and indemnities in which an employee participates because the employee owns stock or options to purchase stock, in an employer that is sold in a change-in-control event.

the potential loss of deduction under Section 162(m), the payment must be made either during the employee's first taxable year in which the employer reasonably anticipates that the deduction will not be barred by Section 162(m) or the period beginning on the employee's separation from service and ending on the later of the end of the calendar year of the separation from service or two and a half months following the separation from service. As described in "Identify Plans Subject to Section 409A—Short-Term Deferrals", these rules permitting certain delays in payment are not available if the plan does not specify a payment date subject to the delay.

Back-to-Back Arrangements of Investment Managers. Under the rules described in "Identify Plans Subject to Section 409A – Service Providers" above, compensation arrangements between investment managers and their clients will generally be subject to Section 409A. In this regard, the regulations provide relief for so-called back-to-back deferred compensation arrangements. Typically, under such arrangements, an investment manager maintains a deferred compensation arrangement for its employees and also defers receipt of the manager's own fees under a separate deferred compensation arrangement with the investment fund. Distributions under the manager's arrangement with its employees trigger distributions under the fund's arrangement with the manager. In such cases, the regulations provide that the deferred compensation arrangement between the fund and the manager may expressly provide for payments to the manager upon the occurrence of a payment event (that is permitted by Section 409A) under the manager's deferred compensation arrangement for its employees. For example, if payments are made under the manager's deferred compensation arrangement for its employees upon an employee's separation from service from the manager, the fund's payment to the manager of the amount due to the separated employee may constitute a permissible payment event under Section 409A (if each of the arrangements otherwise comply with Section 409A, regardless of whether such arrangements are subject to Section 409A). However, Section 409A does not permit so-called reverse back-to-back deferred compensation arrangements (although the preamble to the regulations states that Treasury is continuing to study the matter). For example, in the event that a manager terminates service with a fund client and, pursuant to its investment management agreement with the fund, the manager's deferred fees are paid to the manager (this is a "separation from service" of the manager from the fund, which is a permissible payment event under Section 409A), a resulting payment to the manager's employees of their deferred compensation (presumably, based on some sort of formula) is not permitted.

Terminate Plans Only in Accordance With Section 409A

In order to terminate a nonqualified deferred compensation plan, other than in the context of a corporate dissolution, bankruptcy or change-in-control event, the regulations require that (i) the termination not be proximate to a downturn in the financial health of the employer, (ii) all plans of the same type (using the plan aggregation rules) are terminated with respect to all employees, (iii) no liquidated distributions are made within 12 months of the plan termination, (iv) all payments under the plan are made within 24 months of the plan termination and (v) no new plans of the same type as the terminated plan are adopted in the three years following the plan termination.⁷ Employers are also permitted to terminate plans and make distributions during the 30 days preceding or 12 months following a change-in-control event, provided that all plans of the same type are also terminated.

Review Stock-Based Plans

Nonstatutory Stock Options. Nonstatutory stock options are not treated as deferred compensation subject to Section 409A if they satisfy the following conditions: (i) the option exercise price may never be less than the fair market value of the underlying stock on the date the option is granted; (ii) the number of shares subject to the option is fixed on the grant date; (iii) the option is taxed as an option under the Code; (iv) the option does not include any deferred compensation features other than the right to defer income recognition until exercise or disposition of the option or the later vesting of the stock purchased upon exercise of the option;⁸ and (v) the stock subject to the option satisfies the requirements described below in "Rules Concerning Nonstatutory Stock Options and SARs—(i) Type of stock."

⁷ A right to receive unvested stock upon the exercise of an option and the right to exercise an option with already owned shares do not constitute features for the deferral of compensation. The presence in an omnibus stock compensation plan of an additional deferral feature will not cause any option or SAR awarded under that plan to be subject to 409A unless the terms of the particular award contain such an additional deferral feature.

⁸ A lapse restriction is generally any restriction other than a restriction that (a) by its terms will never lapse and (b) requires the employee to sell or offer to sell, the property (including a permanent right of first refusal in a particular person) at a price determined under a formula (other than at fair market value) and will continue to apply to the employee or any subsequent holder of the property (other than the employer). A lapse restriction generally functions as a vesting condition.

Stock Appreciation Rights. The regulations treat stock appreciation rights (“SARs”) similarly to stock options, regardless of whether the SAR is settled in cash or stock and regardless of whether the SAR is based on stock of a public or nonpublic corporation. SARs are not treated as deferred compensation subject to Section 409A if they satisfy the following conditions: (i) the compensation payable under the SAR is not greater than the excess of the fair market value of the stock on the SAR grant date (without regard to any lapse restrictions)⁹ and the SAR exercise price; (ii) the number of shares subject to the SAR is fixed on or before the grant date; (iii) the SAR exercise price may never be less than the fair market value of the underlying stock (disregarding any lapse restrictions) on the date the SAR is granted; (iv) the SAR does not include any feature for the deferral of compensation other than the deferral of income recognition until the exercise or disposition of the SAR and (v) the stock subject to the SAR satisfies the requirements described below in “Rules Concerning Nonstatutory Stock Options and SARs—(i) Type of stock.”

Rules Concerning Nonstatutory Stock Options and SARs. The regulations contain the following additional rules concerning nonstatutory stock options and SARs:

- (i) *Type of Stock.* The deferred compensation exclusion for nonstatutory stock options and SARs is only available if the stock subject to the options or SARs: (a) is issued by the corporation to whom the employee is providing services and any corporation above that corporation in a direct chain of corporations that all have a controlling interest in one another (a controlling interest is generally defined as a 50 percent common ownership requirement or a 20 percent common ownership requirement if the grant is based on legitimate business criteria), (b) is common stock for purposes of Section 305 of the Code and (c) does not have any preferential rights (other than preferential rights as to distributions of service-recipient stock and distributions in liquidation of the issuer). Such stock is referred to in the regulations as service-recipient stock.
- (ii) *ADRs/ADSs.* American Depositary Receipts (“ADRs”) and American Depositary Shares (“ADSs”) are considered stock if the stock underlying the ADRs or ADSs satisfies the requirements set forth in (i) above.
- (iii) *Fair Market Value.* In applying the foregoing rules, the “fair market value” of the stock is relevant in determining the permissible exercise price of an option or SAR, the permissible payment upon exercise of a cash-settled SAR and the permissible purchase price upon exercise of a put or call right applicable to the underlying stock. The regulations provide the following rules for determining fair market value of stock for purposes of stock rights.
 - (a) *Public Corporation.* If the stock is readily tradable on an established securities market, the fair market value of the stock may be determined using the last sale before or the first sale after the grant of the option, the closing price on the trading day before or the trading day of the grant, the arithmetic mean of the high and low prices on the trading day before or the trading day of the grant or any other reasonable method using actual transactions in the stock as reported by such market. The determination of fair market value may be determined using an average price of the stock during a specified period within 30 days before and 30 days after the applicable valuation date, so long as the terms of the grant (i.e., the recipient, the number and class of shares and the method of determining the exercise price) are irrevocably established before the beginning of this measurement period. The regulations include an exception to the valuation requirements described above for non-US options that are subject to laws mandating that the option price be determined using a specific averaging method or period, provided that the averaging period does not exceed 30 days.
 - (b) *Private Corporation.* If the stock is not readily tradable on an established securities market, the fair market value of the stock may be determined through the reasonable application of a reasonable valuation method.¹⁰ The regulations clarify that it is not necessary that the fair market value be determined by an independent appraiser in order to be reasonable. Reasonableness is determined based on the facts and circumstances as of the valuation date, taking into account a number of relevant valuation factors listed in the regulations. The factors include, among others, control premiums, discounts for lack of marketability, whether the valuation method is used for other purposes that have a material economic effect on the issuer, its stockholders or its creditors and recent arm’s-length transactions involving the sale or transfer of

⁹ The regulations clarify that a private corporation can use one valuation method to determine the exercise price of an option and another valuation method to establish the cash payment upon exercise, provided, however, that, once used, the valuation method may not be retroactively altered.

¹⁰ A nonlapse restriction is generally a restriction that (a) by its terms will never lapse and (b) requires the employee to sell or offer to sell, the property (including a permanent right of first refusal in a particular person) at a price determined under a formula (other than at fair market value) and will continue to apply to the employee or any subsequent holder of the property (other than the employer).

the stock. A valuation method that does not take into consideration all available information material to the value of the corporation is not reasonable. A previously calculated value is not reasonable if it fails to reflect all information available after the date of the calculation that may materially affect the value of the corporation or if the calculation is more than 12 months out of date. The use of one of the following valuation methods is presumed to result in a reasonable valuation (such presumption is rebuttable only upon a showing by the IRS that the valuation method or its application was grossly unreasonable):

- A valuation by an independent appraisal that satisfies the Code requirements for the valuation of stock held in an employee stock ownership plan (an "ESOP") and the value determined by that appraisal will be presumed reasonable for one year after the effective date of the appraisal
- A valuation method based on a nonlapse restriction¹¹ if the method is required to be used for all compensatory and non-compensatory transactions with the issuer or a person owning 10 percent or more of the stock of the issuer, but is not required to be used for transactions with other persons or transactions that are part of an arm's-length sale of all or substantially all of the outstanding stock of the issuer
- A valuation of illiquid stock of a start-up corporation that is made reasonably and in good faith by persons with significant knowledge and experience or training in performing similar valuations and is evidenced by a written report that takes into account the relevant valuation factors set forth in the regulations (referred to above). Stock is generally considered illiquid stock in a start-up corporation if (i) the corporation (directly or indirectly through a predecessor) has not conducted any material trade or business for 10 or more years, (ii) none of the corporation's equity securities is traded on an established securities market, (iii) the stock being valued is not subject to any put or call right or obligation, other than a right of first refusal upon an offer to purchase by a third party that is unrelated to the corporation or employee or a lapse restriction and (iv) it cannot be reasonably anticipated that the corporation will have a change-in-control within 90 days or a public offering of its securities within 180 days, following the option or SAR grant date or other action to which the valuation is applied

(c) *Outstanding Stock Options and SARs.* For stock options and SARs issued before January 1, 2005 (which generally would have been nonvested as of January 1, 2005 and, therefore, not otherwise excluded under the Section 409A grandfathering provisions), the fair market value determination may be made in accordance with the rules governing incentive stock options. Generally, this deems the exercise price to be set at fair market value if there was a good-faith attempt to set the exercise price at fair market value. With respect to options and SARs issued on or after January 1, 2005 but before January 1, 2008, the determination of fair market value may be made using any reasonable valuation method

(iv) *Dividend Equivalents Related to Options or SARs.* A right to a dividend equivalent payment upon the exercise of an option or SAR is generally treated as a reduction in the exercise price (or an increase in the amount payable under a SAR) that subjects the option or SAR to Section 409A if the right to such payment is contingent upon the exercise of the option or SAR.

(v) *Modifications, Extensions and Adjustments of Options and SARs.*

(a) *Modifications.* The regulations describe the effect of a modification of an outstanding option or SAR. An option or SAR is considered modified, whether or not the holder in fact benefits, if any change in the terms of the option or SAR may provide the holder with a direct or indirect reduction in the exercise price of the option or SAR. A modification is treated as the grant of a new option or SAR (except as described in paragraph (v)(c) below). This is important because, while the original option or SAR may not have been subject to Section 409A, the option or SAR deemed newly granted may fail the requirement that the exercise price is at least equal to the fair market value of the stock on the deemed new grant date and, accordingly, become subject to the requirements of Section 409A. The option or SAR deemed newly granted may satisfy the requirements for exclusion from Section 409A on the deemed new grant date. The regulations, however, state that none of the following changes to an outstanding option or SAR (which is not subject to Section 409A) would be a modification: (1) accelerating or delaying the exercisability of the option or SAR, (2) allowing the option or SAR to be transferred (but only if discretion to allow transferability is specifically reserved by the grantor under the option or SAR), (3) allowing the option or SAR to be exchanged for

¹¹ For example, the modification of an incentive stock option to give an employee the right to elect to receive cash, instead of stock, upon exercise of the option, will disqualify the option as an incentive stock option, but will generally not subject the option to Section 409A.

cash equal to the spread between the fair market value of the stock and the exercise price, (4) allowing payment of the exercise price of the option using pre-owned stock or (5) allowing withholding of shares to pay the exercise price or employment or withholding taxes.

The following changes to an option or SAR would be modifications or extensions under the regulations, as applicable: (i) to give the grantor discretion to provide an additional benefit under the option or SAR that, if provided to the holder, would constitute a modification or extension and (ii) a change in the terms of the underlying stock that increases the value of the stock, other than as described in paragraph (v)(c) below, such as a change in a put or call right or the elimination of a non-lapse restriction.

(b) *Extensions.* Generally, the extension of an option or SAR subjects the option or SAR to Section 409A from the original grant date. An extension occurs when an employee is provided with an additional period of time within which to exercise an option or SAR beyond the originally prescribed terms of the option or SAR, when an option or SAR is converted into a legally binding right to receive compensation in a future year or when an additional deferral feature not permitted under Section 409A is added to an option or SAR. However, the following are not considered extensions: (1) extensions of the exercise period to a date no later than the earlier of 10 years from the date of grant or the end of the maximum term for which the right could have been exercised under the terms of the plan, (2) extension of a stock right at a time when the exercise price is in excess of the fair market value of the shares underlying the option or SAR (which extension is considered the new grant of an option or SAR that is exempt under Section 409A) and (3) extensions due to the employee's inability to exercise the option or SAR without violation of applicable federal, state, local and foreign laws or because the exercise would jeopardize the employer's ability to continue as a going concern, provided that the extension does not extend more than 30 days after the date on which the option or SAR could be exercised without such effect.

(c) *Adjustments to Reflect Capital Changes or Corporate Transactions Not Treated as New Grant.* For outstanding stock options and SARs to continue to be excluded from Section 409A, any adjustments must comply with the requirements of the regulations. In the event of a stock split, reverse stock split or stock dividend that increases or decreases on a pro rata basis the number of shares of stock, the number of shares subject to and the exercise prices of, outstanding options or SARs may be proportionately adjusted to reflect such event provided that the aggregate exercise price of the option or SAR is not less than the aggregate exercise price before such event. In the event of a corporate transaction (which is defined as set forth in the rules applicable to incentive stock options), the substitution or assumption of outstanding options or SARs will not be treated as a grant of new options or SARs or a change in the form of payment if, in general, the substitution or assumption conforms to the corporate transaction rules applicable to incentive stock options. Generally, these rules require that: (1) the aggregate spread between the fair market value of the underlying stock over the aggregate exercise price immediately after the substitution or assumption does not exceed the aggregate spread immediately before the substitution or assumption; (2) the ratio of the exercise price to the fair market value of the underlying stock immediately after the substitution or assumption is not greater than the ratio of the exercise price to the fair market value of the stock immediately before the substitution or assumption and (3) the new or assumed options or SARs have all the terms and conditions of the old options or SARs and do not give the holder additional benefits that the holder did not have under the old options or SARs. The regulations clarify that the holder of the option or SAR does not need to be employed by the successor entity in order for this exception to apply.

(vi) *Definitions.* The regulations incorporate several definitions from the rules applicable to incentive stock options, such as "date of grant," "exercise price," "stock" and "transfer." The date of grant of an option or SAR is the date when all necessary corporate action is taken to create a legally binding right to the option or SAR. All necessary corporate action is considered taken when the maximum number of shares and the minimum exercise price are fixed and determinable and the class of underlying stock and the recipient are identified. An unreasonable delay in the notification of the recipient of the grant of the option or SAR, is an indication that the grant date is the subsequent date on which notice is given.

Statutory Stock Options. Incentive stock options (described in Section 422 of the Code) as well as options granted under a qualified employee stock-purchase plan (described in Section 423 of the Code) (collectively, "statutory stock options") are excluded from treatment as deferred compensation under Section 409A. The existing statutory stock option regulations provide that a modification, extension or renewal of a statutory stock option is considered the granting of a new option. This new option may fail to be a statutory stock option or be disqualified because it fails the relevant exercise price

requirements on the new grant date, e.g., the new option may not be an incentive stock option because the fair market value of the stock on the new grant date exceeds the existing exercise price of the option. The regulations provide that if a modification results in the disqualification of a statutory stock option, that option will only be subject to Section 409A if such modification would have been treated as a new grant for Section 409A purposes if the incentive stock option had been a nonstatutory stock option at its original grant date.¹² In that case, the modification giving rise to this disqualification of the option may be treated as the grant of a new option for purposes of Section 409A (see “Rules Concerning Nonstatutory Stock Options and SARs” above).

Restricted Stock. Restricted stock, which is includible in income as it vests, based on continued service or other vesting criteria or with respect to which the employee elects to be taxed immediately under Section 83(b) of the Code, is not subject to Section 409A. A legally binding right to receive stock that will be vested at the time of transfer in a later taxable year, such as a restricted stock unit (discussed below), may constitute deferred compensation subject to Section 409A. A legally binding right to receive stock that will be unvested at the time of transfer in a later taxable year, such as an agreement to provide restricted stock, will not constitute deferred compensation subject to Section 409A (unless offered in conjunction with another legally binding right that does constitute a deferral of compensation).

Dividend Equivalents. An employee’s contractual right to receive payments based on dividends that the corporation pays on a specified number of shares of stock which the employee does not actually own, is commonly referred to as a dividend equivalent right. Dividend equivalents may be paid in cash or stock. The regulations provide that dividend equivalents based on dividends paid to stockholders do not violate Section 409A if the dividend equivalents are paid no later than the 15th day of the third month following the calendar year in which the dividends are declared. Dividend equivalents can also be payable upon a payment event that is permitted under Section 409A (e.g., a separation from service) or in compliance with the short-term deferral exception described under “Identify Plans Subject to Section 409A—Short-Term Deferrals” above. However, dividend equivalents related to options or SARs are subject to additional rules, as described under “Rules Concerning Nonstatutory Stock Options and SARs—(iv) Dividend Equivalents Related to Options or SARs” above.

Restricted Stock Units. Restricted stock units (i.e., deferred compensation obligations based on the value of stock) are generally subject to Section 409A, unless the restricted stock unit is structured to meet the short-term deferral exception described under “Identify Plans Subject to Section 409A—Short-Term Deferrals” (see above). For example, if the restricted stock unit provides that payment is to be made within two and a half months after the end of the tax year of vesting, the restricted stock unit will not be subject to Section 409A. If the short-term deferral exception is not met, restricted stock units can be structured to comply with Section 409A’s requirements by having a fixed payment date or requiring a payout upon a permissible payment event, such as a separation from service.

Grandfathering Rules Relevant to Stock-Based Plans. A stock option or SAR that on or before December 31, 2004, was exercisable for cash or vested stock is treated as earned and vested, even though the option or SAR could be forfeited upon termination of the holder’s employment. Likewise, an increase in the amount payable under an option, SAR or other stock-based compensation above the amount available on December 31, 2004, due to appreciation in the underlying stock or accrual of other earnings such as dividends after December 31, 2004, is treated as earnings on the amount available on December 31, 2004, so that if that amount is grandfathered, those future earnings are similarly grandfathered and not subject to Section 409A.

Recommendations. Employers should review all outstanding options and SARs to ensure that their exercise prices were at least equal to the fair market value of the underlying stock on their respective grant dates and that the terms and conditions of the options or SARs do not otherwise cause them to be treated as providing a deferral of compensation under Section 409A. The nationwide scandal involving improper stock option “backdating” (e.g., when a date earlier than the formal grant date is selected as the grant date for purposes of setting the exercise price of the options) has clear potential ramifications under Section 409A. A determination should be made as to whether the option or SAR is eligible to be grandfathered and therefore not subject to Section 409A and, if so, whether the option or SAR will continue to be treated as grandfathered until it is exercised. If an outstanding option or SAR would be subject to Section 409A, such option or SAR, under applicable transition rules, may be cancelled and replaced with an option or SAR that would not have constituted a deferral of compensation under Section 409A (e.g., the exercise price of the replacement option or SAR may be

¹² For example, the modification of an incentive stock option to give an employee the right to elect to receive cash, instead of stock, upon exercise of the option, will disqualify the option as an incentive stock option, but will generally not subject the option to Section 409A.

increased to the fair market value of the underlying stock on the grant date of the option or SAR). Generally, such a cancellation and reissuance of an option or SAR may occur at any time prior to December 31, 2008. However, the exercise of a discounted option or SAR in 2008, before it is replaced, will result in a violation of Section 409A. This relief is not available for any stock option or SAR that was granted with respect to stock of public corporation, to a person who was subject to disclosure requirements under Section 16 of the Securities Exchange Act of 1934, as amended, at the time of grant and with respect to the grant of such stock option or SAR, such corporation either has reported or reasonably expects to report a financial expense due to the issuance of a stock option or SAR with an exercise price lower than the fair market value of the underlying stock on the date of grant that was not timely reported on financial statements or reports for the period in which the related expense should have been reported. Where a discounted option or SAR is replaced with an option or SAR not subject to Section 409A, the employer may compensate the holder by paying or providing the holder with new options or other awards in an amount based on the aggregate increase in the exercise price of the old option, provided that such options or awards are not subject to or comply with, Section 409A. However, payments of cash or vested property made in the year of cancellation to compensate for a lost discount will not comply with Section 409A.

Identify Performance-Based Compensation and Prepare to Establish Performance Criteria

Employers should identify performance-based compensation plans in 2009 and prepare to establish performance criteria not later than 90 days after the beginning of any performance period (e.g., for 2009 annual performance bonuses, performance criteria should be established before or within the first 90 days of the year). Qualifying as performance-based compensation is significant because deferral elections with respect to performance-based compensation may be made until six months before the end of the performance period, provided that the compensation is not readily ascertainable at that time. In order to qualify as performance-based compensation, the payment of the compensation or the amount of the compensation must be contingent on the satisfaction of pre-established organizational or individual performance criteria relating to a performance period of at least 12 months and the employee must perform services continuously from the time the performance criteria are established through the date of the election. Organizational or individual performance criteria are pre-established if set forth in writing no later than 90 days after the commencement of the period of service to which the criteria relates, provided that the outcome is substantially uncertain at such time. Performance-based compensation may include amounts paid based solely on the value or appreciation in value, of the employer, such as stock options or stock appreciation rights, with an exercise price that is less than the grant date fair market value of the underlying stock and, therefore, are subject to Section 409A, provided that the receipt of such amounts are contingent upon the attainment of pre-specified performance criteria. Compensation will not fail to be performance-based because it is payable in the event of death, disability or a change-in-control event, provided that if the compensation is actually paid upon such event, the deferral election rules applicable to performance-based compensation will not apply.

Review Separation Pay Plans

Separation pay arrangements, including severance provisions in employment agreements, are generally subject to Section 409A unless the arrangement satisfies an exception. Thus, employers should review their separation pay plans to determine whether they are subject to Section 409A. The regulations clarify and expand several of the exemptions from Section 409A that are applicable to separation pay plans and also provide guidance to facilitate compliance of separation pay plans that are subject to Section 409A.¹³

Severance Payments Limited in Amount. A separation pay plan where severance is paid upon an involuntary separation from service or pursuant to a "window program" is exempt from Section 409A to the extent the amount paid under such plan to any employee does not exceed two times the employee's compensation for the year prior to separation (or, if less, two times the annual compensation limit then applicable to tax-qualified plans, which limit is US\$230,000 for 2008) and is paid no later than December 31 of the second calendar year following the calendar year in which the employee's separation from service occurs. Notably, this exclusion will apply to payments up to the limit described above, even where the entire amount of the separation payment exceeds the limit. As a result, this exception can be used to deliver compensation, up to the limit specified above, to a specified employee to whom the six-month delay in payments applies, even during the applicable six-month delay period. However, the regulations clarify that separation pay does not include amounts payable upon separation from service that could be received without the employee's separation from service (i.e., amounts that are also payable upon a change in control, as a result of an unforeseeable emergency or on a certain date). Amounts

¹³ See also Andrew L. Oringer, "Terminating the Six-Month Delay on Severance Payments Under the Deferred Compensation," *Tax Notes*, July 2007.

paid upon separation from service in substitution for or replacement of, amounts deferred under a separate plan that would have otherwise been forfeited upon a separation from service are deemed to be paid under the separate plan (and, as a result, the vesting and payment of such amounts upon a separation from service may be an impermissible acceleration).

Short-Term Deferrals. Amounts payable upon an involuntary separation from service are deemed to be subject to a substantial risk of forfeiture until such involuntary separation from service occurs. Consequently, such amounts will not be subject to Section 409A if paid within the time period required to qualify as a short-term deferral (generally, within two and a half months following the end of the year in which the involuntary separation from service occurs). A right to payment upon a separation from service for “good reason” may be treated as a right to payment upon an involuntary separation from service (as discussed below) and, if so, that payment right may be treated as subject to a substantial risk of forfeiture until the employee actually terminates employment due to such good reason condition.

Definition of Involuntary Separation from Service. The regulations provide circumstances under which an employee’s separation from service will be considered as an involuntary separation from service. How a termination is characterized (as a voluntary or involuntary separation from service) in the applicable separation documents is rebuttably presumed to be correct.

The regulations provide that an employee’s separation from service for “good reason” may qualify as an involuntary separation from service. As a result, taxpayers can use good reason definitions in separation pay arrangements and retain the potential to have amounts paid thereunder excluded from the definition of nonqualified deferred compensation, either because such amounts qualify as short-term deferrals or meet the requirements for certain excluded separation pay arrangements, described above.

The regulations permit the use of a general method and a safe harbor method, for determining whether an involuntary separation from service based on the occurrence of a good reason event has occurred. The general method allows an employee’s voluntary separation from service to be treated as an involuntary separation from service if the separation occurs under certain limited bona fide conditions, where the avoidance of Section 409A is not a purpose for including those conditions in the plan or agreement or if the employee’s actions in connection with satisfaction of these conditions and voluntary separation under these conditions effectively constitutes an involuntary separation from service. These conditions should be pre-specified in the compensation agreement. More specifically, the general method provides that an involuntary separation from service requires actions taken by the employer resulting in a material negative change in the employment relationship, such as a negative change in the duties to be performed, the conditions under which such duties are performed or the compensation received. Additional factors to be considered are whether the same amount is paid, at the same time and in the same form, upon a good reason separation from service as would be paid upon an actual involuntary separation from service by the employer and whether the employee is required to give notice of and the employer is given the opportunity to cure, the condition giving rise to good reason.

The safe harbor method lists several specific conditions that must be met in order for a good reason separation from service to qualify as an involuntary separation from service: (i) the separation from service must occur within a predetermined limited period of time not to exceed two years, following the initial existence of the good reason condition, (ii) the employee must provide notice to the employer of the good reason condition within 90 days of the initial existence of the condition and (iii) the employer must be given at least 30 days to cure the good reason condition. The regulations set forth the following acceptable good reason conditions for purposes of the safe harbor method, any one or more of which may be specified in the applicable plan or agreement and which must arise without the employee’s consent: (a) a material diminution in the employee’s base compensation, (b) a material diminution in the employee’s authorities, duties or responsibilities, (c) a material diminution in the authorities, duties or responsibilities of the supervisor to whom the employee reports, (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 services and (f) any other action or inaction that constitutes a material breach of the employee’s employment agreement.

Reimbursements, In-Kind Benefits and Direct Payments. Section 409A does not apply to the following reimbursements, benefits and payments that are available during a limited time period following separation from service (whether voluntary or involuntary): (i) reimbursements that are otherwise excludable from income for reimbursements for expenses that the employee can deduct under Section 162 or Section 167 of the Code as business expenses (ignoring limitations based on adjusted gross income), (ii) reasonable outplacement expenses, (iii) reasonable moving expenses,

(iv) reimbursements for deductible medical expenses (ignoring limitations based on adjusted gross income), (v) taxable reimbursements of medical expenses during the period in which the employee could elect coverage under the “COBRA” rules of Section 4980B of the Code and (vi) in-kind benefits or direct payments from the employer that would otherwise not be subject to Section 409A under the foregoing rules if paid as reimbursements. Except as noted above, such reimbursable expenses must be incurred and in-kind benefits must be provided, by the last day of the second taxable year following the taxable year in which the employee’s separation from service occurs (and reimbursements must be paid by the last day of the third taxable year following such year of separation). In addition, reimbursements, payments or benefits provided only on separation from service that do not exceed the limit in Section 402(g) of the Code (US\$15,500 in 2008) in the aggregate are not subject to Section 409A. The regulations also include new exemptions for indemnifications for legal expenses, liability insurance, legal settlements and educational benefits to the employee. Note that reimbursements (or payments) for many types of benefits and perquisites that are often provided to senior-level employees following a separation from service (such as the continued payment of life insurance premiums or use of a corporate airplane) will be subject to Section 409A unless such reimbursements would otherwise be excluded from income or deductible under Section 162 or Section 167 of the Code. However, the regulations also include several provisions, described below, that will make it easier for plans that provide such benefits to comply with Section 409A.

Collectively Bargained Plans. Any plan that provides separation pay upon an actual involuntary separation from service or pursuant to a “window program” is not subject to Section 409A if the plan is contained in a bona fide collective bargaining agreement (as determined by the Secretary of Labor) that was bargained in good faith and the separation pay was the subject of arm’s-length negotiations.

Structure to Comply with Section 409A. Reimbursements or in-kind benefit plans will be deemed to provide payments at a specified time or on a fixed schedule, in compliance with the payment event rules of Section 409A, if the plan provides for reimbursements of or in-kind benefits with respect to, expenses that are objectively determinable and nondiscretionary benefits during an objectively prescribed period and the amount reimbursable in one tax year does not affect the amount reimbursable in another year and the reimbursement payment is made by the end of the employee’s taxable year following the taxable year in which the expense is incurred. Such benefits may not be subject to liquidation or exchange for another benefit. For example, an agreement to provide reimbursement for up to US\$30,000 in club dues over three years would not comply with Section 409A but an agreement to provide club dues for up to US\$10,000 per year for three years would generally comply with Section 409A. Medical plans, however, may include lifetime medical limits or other maximum benefit levels. Tax gross-up payments are also considered to provide for distributions at a specified time or on a fixed schedule, if the payments are made no later than the end of the taxable year following the taxable year in which the related taxes are paid to the government. Similar rules apply to the payment of expenses associated with a tax audit or litigation related to a tax liability. Severance pay that is contingent upon the execution of a release of claims against the employer should be carefully structured to comply with the requirements for short-term deferrals or payment upon a permissible payment event, as applicable.

Make Changes to Nonqualified Deferred Compensation Plans Linked to Qualified Plans

The regulations provide certain rules with respect to the linking of: (i) deferral elections and/or formulas for benefit accruals under a tax-qualified retirement plan and a nonqualified deferred compensation plan and (ii) the time and form of benefit payment elections under a tax-qualified retirement plan and a nonqualified deferred compensation plan.

Background. Employers often “link” a tax-qualified retirement plan to a nonqualified deferred compensation plan in order to provide certain of their designated employees with benefits under the nonqualified deferred compensation plan to the extent that the Code’s maximum contribution limits, benefit limits and/or discrimination rules limit the amount of benefits that can be provided to such employees under such tax-qualified retirement plan. In this regard, where contributions and/or distributions under a nonqualified deferred compensation plan are linked as to contributions and/or distributions under a tax-qualified retirement plan, a change in the applicable provisions of and/or elections under, the tax-qualified retirement plan typically have a related effect on the nonqualified deferred compensation plan. For example, absent regulatory relief, (i) a deferral election decrease under a tax-qualified retirement plan that results in a corresponding increase in the amount credited under a linked nonqualified deferred compensation plan, may not comply with Section 409A’s rules with respect to the timing of deferral elections and (ii) a deferral election increase under a tax-qualified retirement plan that results in a corresponding decrease in the amount credited under a linked nonqualified deferred compensation plan, may violate Section 409A’s general prohibition on the acceleration of payments under a nonqualified deferred compensation plan. Similarly, provisions in a nonqualified deferred compensation plan linking distributions to tax-qualified plan distributions, could violate Section 409A’s rules that require a deferral election to state the time and form of payment and that strictly limit subsequent changes to the time and form of payments.

Linking of Deferral Elections and/or Formulas for Benefit Accruals. With respect to amounts deferred under a nonqualified deferred compensation plan that is linked to a tax-qualified retirement plan, neither the increase or decrease in amounts deferred under the nonqualified plan that results directly from changes in benefit limitations applicable to the tax-qualified retirement plan under the Code (provided that such change is not in excess of the change in the amounts deferred under the tax-qualified plan and that such operation does not otherwise result in a change in the time or form of a payment under the nonqualified deferred compensation plan) nor the following actions or inactions will constitute a deferral election and/or an accelerated payment of deferred compensation under the Section 409A rules, even if such action or inaction results in an increase or decrease in amounts deferred under the nonqualified deferred compensation plan:

- (i) an employee's election of or failure to elect, a subsidized benefit or an ancillary benefit under the tax-qualified retirement plan that results in amounts payable under a nonqualified deferred compensation plan being increased or decreased relative to the lesser or greater benefit payable under the tax-qualified retirement plan;
- (ii) an employer's amendment of the tax-qualified retirement plan to increase, decrease or freeze benefits under such plan or to add or remove a subsidized benefit or an ancillary benefit (e.g., a benefit increase under the tax-qualified plan that results in a corresponding decrease in the amounts payable under the nonqualified deferred compensation plan) or
- (iii) an employee's action or inaction under a plan that is intended to qualify under Section 401(k) of the Code (including an adjustment to an existing deferral election under such plan), provided that such action or inaction does not result in an increase or decrease in the amounts deferred under all nonqualified deferred compensation plans in which the participant participates (other than changes in matching contributions, described in (iv) below) in excess of the maximum annual 401(k) contribution limit (which limit is US\$15,500 for 2008), as may be increased by the Section 414(v) catch-up contribution limit (which limit is US\$5,000 for 2008) if the employee is at least 50 years old or
- (iv) an employee's action or inaction under a plan that is intended to qualify under Section 401(k) of the Code (including an adjustment to an existing deferral election under such plan), that affects the amounts that are credited to a nonqualified deferred compensation plan as matching or similar contingent amounts, provided that the total of such matching or contingent amounts never exceeds 100 percent of the matching or contingent amounts that would have been provided under the tax-qualified plan absent any plan-based restriction on qualified plan contributions under the Code.

As such, the regulations provide relief for so-called "wrap-around" arrangements (i.e., a nonqualified deferred compensation plan in which, following the performance of non-discrimination tests to ascertain the maximum amount of deferrals an employee could make under a linked tax-qualified plan, the nonqualified deferred compensation plan would transfer such deferrals to the tax-qualified plan).¹⁴ However, the preamble to the regulations states that a similar linked arrangement commonly referred to as a "spill-over" arrangement (whereby a highly compensated employee is permitted to make his or her elective deferred compensation contributions first to the tax-qualified retirement plan and then, once such contributions reach the maximum annual 401(k) contribution limit and/or the maximum amount that would not cause such plan to fail the applicable non-discrimination tests for the year, to the nonqualified deferred compensation plan) will not comply with Section 409A.

Linking of Time and Form of Payment Elections. For periods ending on or before December 31, 2008, an election as to the time and/or form of a payment under a nonqualified deferred compensation plan that is linked to a payment election made by a participant under a tax-qualified retirement plan will not violate Section 409A, provided that the determination of the time and form of the payment is made in accordance with the terms of the nonqualified deferred compensation plan as of October 3, 2004.¹⁵ For example, where a nonqualified deferred compensation plan provided, as of October 3, 2004, that the time and form of payment to a participant will be the same time and form of payment elected by the participant under a

¹⁴ Prior to the enactment of Section 409A, the IRS issued a number of private letter rulings authorizing arrangements pursuant to which a 401(k) arrangement under a tax-qualified retirement plan was "wrapped around" a deferral right under a nonqualified deferred compensation arrangement. Under the typical so-called "wrap-around plan," an employee eligible under both the tax-qualified retirement plan and the nonqualified deferred compensation plan would make deferral elections under the nonqualified deferred compensation plan and the tax-qualified retirement plan. The employee's deferral election (and any related company matching contribution) under the tax-qualified retirement plan would be for the maximum amount permissible under the Code that would not cause such plan to fail the applicable non-discrimination tests (i.e., the so-called "ADP" and "ACP" tests) for the year. However, because such amount would not be determinable until after the end of the applicable tax year, all deferrals (and any related matching contributions) would initially be made to the nonqualified deferred compensation plan. As soon as practicable following the close of the plan year, the plan sponsor would perform the applicable non-discrimination tests to ascertain the maximum amount of deferrals (and related matching contributions) the employee could make under the tax-qualified retirement plan, at which time the nonqualified deferred compensation plan would transfer such deferrals (and related matching contributions) to the tax-qualified retirement plan. Notably, wrap-around plans generally benefit highly compensated plan participants by preventing the tax-qualified retirement plan from failing the Code's non-discrimination tests, thereby preventing the need for such a highly compensated participant to receive corrective distributions of any portion of the amounts he or she attempted to defer under the tax-qualified retirement plan to the extent that such plan failed the applicable non-discrimination tests. Because nonqualified deferred compensation plan benefits are reduced by the deferrals that are transferred to a tax-qualified retirement plan that is "wrapped around" such nonqualified deferred compensation plan, after the passage of Section 409A and the release IRS Notice 2005-1, it was widely believed that such a "reduction" (and the related "transfer" of such benefits from the nonqualified deferred compensation plan to the tax-qualified retirement plan) would result in a prohibited acceleration of payments.

related tax-qualified retirement plan, it will not be a violation of Section 409A for the nonqualified deferred compensation plan to make or commence payments during 2008 pursuant to the payment election under the related tax-qualified retirement plan.

Thus, as of January 1, 2009, the time and form of benefit payment options under a nonqualified deferred compensation plan and a tax-qualified retirement plan must be de-linked. In order to de-link such plans, the time and form of payment options under the nonqualified deferred compensation plan will need to be brought into compliance with Section 409A as of January 1, 2009. Participants will likely need to make new payment elections for amounts previously deferred under such a nonqualified deferred compensation plan, to the extent that such amounts are treated as grandfathered under Section 409A. Such new payment elections must be made by December 31, 2008. Going forward, elections with respect to the time and form of distributions of deferred compensation will need to be made by participants in the nonqualified deferred compensation plan at the time of the deferral election, as opposed to at some later date, as is typically permitted under a tax-qualified retirement plan and such participants will have a limited ability under Section 409A to make changes to their initial elections.

Notably, the result of this change in law is that the timing of distribution elections under a nonqualified deferred compensation plan, after the requisite changes are made to bring such plan into compliance with Section 409A and the timing of distribution elections under a tax-qualified retirement plan may not match, notwithstanding the fact that such plans were originally established to be “mirror” plans in this regard.

Comply With Reporting and Withholding Requirements

Section 409A generally requires that amounts deferred must be reported on an individual’s Form W-2 or Form 1099-MISC for the year of deferral even if the amount is not currently includible in income for that taxable year. Amounts included in income under Section 409A are also subject to applicable reporting and income tax withholding requirements. The regulations do not include provisions relating to income inclusion on a violation of Section 409A and further guidance on the application of these rules is expected.

Notice 2006-100 and Notice 2007-89 provide interim guidance to employers on their reporting and wage withholding requirements for calendar years 2005, 2006 and 2007. Employers are encouraged to review the requirements of Notice 2006-100 and Notice 2007-89 for details regarding the reporting of nonqualified deferred compensation for 2005, 2006 and 2007. Highlights of Notice 2007-89 include the following:

For calendar year 2007, employers are not required to report amounts deferred during the year under a nonqualified deferred compensation plan subject to Section 409A, unless such amounts are includible in income (i.e., nonqualified deferred compensation that does not comply with Section 409A must be reported, but reporting is not required for nonqualified deferred compensation that complies with Section 409A).

Employers are required to report all vested amounts that are includible in income under Section 409A during 2007. Employers must also withhold federal income taxes on such includible amounts. The includible amount (if not previously actually or constructively received) is determined as of December 31, 2007 for reporting and withholding purposes. No additional withholding is required with respect to the additional 20 percent income tax and interest on includible amounts.

Employers may satisfy any Section 409A withholding requirements by either withholding required amounts from the employee’s pay by January 31, 2008 or by paying the withholding tax on behalf of the employee, provided that the employer reports any payment made on behalf of the employee as additional compensation to the employee.

¹⁵ Provisions in a nonqualified deferred compensation plan that link distributions under such plan to distributions under a tax-qualified retirement plan could violate Section 409A’s requirements relating to the time and form of benefit payments. Specifically, the applicable rules under Section 409A require an election to defer the payment of compensation to state the time and form of payment and strictly limit subsequent changes to such time and form of payment, whereas tax-qualified retirement plans often permit elections as to time and form of payment to be made at a future point in time (e.g., upon reaching a particular age or a separation from service).

Monitor Assets Held in Trusts

Section 409A(b) provides that assets set aside in a trust or other arrangement for purposes of paying nonqualified deferred compensation are treated as property transferred in connection with the performance of services at the time set aside, if the assets are located outside of the United States or at the time transferred, if the assets are subsequently transferred outside the United States. This rule does not apply to assets located outside the United States if substantially all of the services to which the nonqualified deferred compensation relates are performed in such non-United States jurisdiction. Accordingly, holding assets with respect to vested benefits in a foreign “rabbi” trust will result in immediate taxation, plus a 20 percent additional income tax and applicable interest under Section 409A, unless the aforementioned exception applies. Section 409A(b) also provides that employees are currently taxed if, in connection with any change in an employer’s financial health, assets are or would become, restricted to the payment of benefits under a nonqualified deferred compensation plan. These rules apply to assets that are set aside to satisfy deferred compensation obligations with respect to deferred compensation otherwise grandfathered under Section 409A, as well as amounts deferred after December 31, 2004.

With respect to assets set aside, transferred or restricted on or prior, to March 21, 2006 so as to be subject to the inclusion rules under Section 409A(b) (“grace-period assets”), taxpayers were not treated as having triggered the income inclusion rules of Section 409A(b) if the nonqualified deferred compensation plan trust came into compliance on or before December 31, 2007 with Section 409A(b) and any other guidance issued before such date. Grace-period assets include actual earnings on those assets, including actual earnings credited after March 21, 2006. Assets (including assets that would otherwise be treated as grace-period assets) that are (i) transferred outside of the United States after March 21, 2006 or (ii) subjected, after March 21, 2006, to a new restriction triggered in connection with a change in the financial health of the employer, will not qualify as grace-period assets. Grace-period assets that were paid and included in income on or before December 31, 2007, will not cause the plan to violate Section 409A(b). If an amount is paid from a trust or other arrangement, where some of the assets of the trust or other arrangement are grace-period assets and some are not, the payment is treated as made first from the grace-period assets.

The regulations do not address the funding requirements of Section 409A(b).

Until further guidance is issued, taxpayers may rely on a reasonable, good-faith interpretation of Section 409A(b) to determine whether the use of a trust or other arrangement causes an amount to be included in income under Section 409A(b). Employers should be careful not to move “rabbi” trust assets outside of the United States or create financial health restrictions on the use of assets for payment of nonqualified deferred compensation in a manner that would cause those assets to be subject to Section 409A(b). For example, any deferrals of compensation contributed to an off-shore “rabbi” trust, would violate Section 409A(b), unless the exception described above applies. As another example, assets that are subjected to a new restriction triggered by a change in the plan sponsor’s financial health would violate Section 409A(b) as of the addition of that restriction.

Correct Operational Failures to Comply with Section 409A

On December 3, 2007, the IRS issued Notice 2007-100, which announces a program allowing taxpayers to correct certain unintentional operational failures under Section 409A. Specifically, Notice 2007-100 provides taxpayers with methods to correct or limit the amount included in income due to, certain unintentional operational failures under Section 409A, provided that such failures (i) are corrected in the same taxable year in which the failure occurs or (ii) involve only de minimis amounts and occur prior to the end of 2010.

Failures under Section 409A must meet certain preliminary requirements in order to be eligible for relief under Notice 2007-100. First, the failure must be an unintentional operational failure, which is an unintentional failure under plan provisions that satisfy the requirements of Section 409A or an unintentional failure to follow the requirements of Section 409A in practice, due to one or more inadvertent errors in the operation of the plan. The failure must also be non-egregious and unrelated to a tax avoidance scheme. In addition, the employer must take commercially reasonable steps to avoid a recurrence of the failure.

The relief is not available after 2008 with respect to any failure or substantially similar failure, that had occurred previously, unless the employer can demonstrate that (i) it established practices and procedures reasonably designed to ensure that such failure would not recur, (ii) it took commercially reasonable steps to avoid a recurrence of such failure and (iii) such failure occurred despite the employer's diligent efforts. Relief is also not available in certain cases where the failure occurs during a year in which the employer experiences a substantial financial downturn. Certain other conditions, such as the timely filing of information with the IRS, may also affect the availability of the relief.

A taxpayer will incur no penalty under Section 409A with respect to unintentional operational failures under Section 409A that are corrected by an employer in accordance with Notice 2007-100 within the employer's same taxable year. Specifically, the following failures, if otherwise eligible for relief, may be corrected, without penalty to the taxpayer, if corrected within the same taxable year:

- (i) payment of amounts that should have been deferred (or continued to be deferred)
- (ii) deferral (or continued deferral) of amounts that should have been paid
- (iii) payment of amounts to specified employees in violation of Section 409A(a)(2)(B)(i) (i.e., the requirement to delay for six months payments to a specified employee upon separation from service)
- (iv) grant of a stock right (i.e., an option or SAR) with an exercise price below the fair market value of the underlying stock on the grant date (provided that such stock right would otherwise have been excluded from the application of Section 409A and that such correction is made in the same taxable year and prior to exercise of the stock right)

Notice 2007-100 provides specific methods for correcting each type of failure, including special correction requirements for company insiders (i.e., directors, officers or ten percent stockholders).

If not corrected in the same year, the operational failures described in the preceding paragraph (with certain exceptions in the case of below-market stock rights) may be corrected in accordance with Notice 2007-100 in later years, while still affording affected taxpayers limited relief from the penalties of Section 409A. If such a failure occurs prior to the end of 2010 and involves amounts that do not exceed the Section 402(g)(1)(B) limit for the taxable year in which the failure occurs (US\$15,500, for 2008), the failure may be corrected by the employer (or service recipient) not later than the end of the employer's second taxable year following the taxable year in which the failure occurs. In the event of such a correction, the amount includible in income under Section 409A as a result of such failure is limited to the amount incorrectly paid or deferred, as applicable and does not include any other amounts deferred under the plan. In addition, with respect to such amount includible in income under Section 409A, the taxpayer will be required to pay the additional 20 percent income tax, but is not required to pay the additional penalty interest provided for by Section 409A.

Employers should identify any operational failures under Section 409A occurring after January 1, 2005 (i.e., the effective date of Section 409A) that can be corrected or addressed, under the program set forth in Notice 2007-100.

Conclusion

Employers should review all of their compensation arrangements to determine whether such arrangements are subject to Section 409A. Employers maintaining nonqualified deferred compensation plans that are subject to Section 409A should operate the plans in compliance with Section 409A at all times and bring the plans into full administrative compliance with Section 409A, under all binding and applicable authority, in no event later than December 31, 2008. Failure to take such actions may result in material adverse tax consequences to employees entitled to compensation under such plans.



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