GROOM LAW GROUP

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Proposed IRS Regulations Provide Reasonable Framework For Redesign of Nonqualified Programs

On September 29th, the IRS issued long-awaited proposed regulations under Internal Revenue Code section 409A. 70 Fed. Reg. 57930 (Oct. 4, 2005). The regulations primarily provide guidance on the scope of section 409A, as well as the rules for deferral elections and distributions under plans subject to section 409A. As widely reported, the regulations also extend most, but not all, of the transition relief for section 409A compliance an additional 12 months to December 31, 2006. On the whole, the guidance is surprisingly favorable and should help ease the transition into the new "post-409A" world for employers and executives.

Section 409A was added to the Code last October when President Bush signed into law the American Jobs Creation Act of 2004 (Pub. L. No. 108-357). The provisions essentially impose "tax qualification" rules on nonqualified plans. They affect virtually every nonqualified plan in existence, including supplements to qualified plans and stock-based compensation arrangements.

On December 20, 2004, the IRS issued Notice 2005-1 providing a conceptual framework for the new rules under section 409A and initial transition guidance.[1] The proposed regulations largely incorporate the concepts described in Notice 2005-1 and provide guidance in numerous areas not addressed in the Notice.

We highlight below the new guidance under the following main headings:

- Key Transition Issues
- Scope of Section 409A
- Deferral Election Rules
- Distribution Rules

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[1] For more information regarding section 409A and Notice 2005-1, please see our summaries at "www.groom.com/_library/ExecutiveCompensation."

I. Key Transition Issues

A. Good Faith Compliance Period Extended Through 2006

Notice 2005-1 provided that a plan adopted before 2006 would not be treated as violating the requirements of section 409A if:

- the plan is operated in good faith compliance with the provisions of the statute and guidance issued by the IRS; and
- the plan is amended by December 31, 2005 to conform to the provisions of section 409A.

The regulations extend this good faith compliance period and the December 31, 2005 deadline for amending plans to December 31, 2006. Because the proposed regulations are not effective until January 1, 2007, compliance with them is not required for good faith compliance during 2006. However, compliance with the regulations will be deemed good faith compliance.

The extension of the transition relief provides continued relief in a number of important areas:

- Employers and plan participants continue to have the ability to change the distribution provisions for amounts subject to section 409A until the end of 2006 within certain limits.
- The relief in Notice 2005-1 allowing distributions under qualified plans to control distributions under nonqualified plans (so called "piggyback elections") continues through the end of 2006.
- Stock options and stock appreciation rights (SARs) that are subject to section 409A (e.g., discounted options) may be replaced with exempt options or SARs through the end of 2006.

With these extensions, plan sponsors should not have to make all of the design decisions regarding their nonqualified deferred compensation plans until after the final regulations are published (hopefully in early 2006).

B. Ability to Cancel or Terminate Not Extended

Not all of the transition rules provided in Notice 2005-1 have been extended into 2006. Most importantly, the ability to cancel a deferral election or terminate participation in a plan in 2005 and receive a distribution of deferred amounts subject to section 409A will not be extended into 2006. This means that if elections to defer are to be revoked in whole or in part, that revocation must be made by the end of 2005 and the conforming plan documentation must be adopted. For many employers, this ability to revoke deferral elections or terminate participation in a plan provided added assurance that there would not be a violation of section 409A during 2005. Without this revocation opportunity, individuals will need to clearly understand the consequences of making deferral elections under the new rules. In addition, an employer's ability to terminate a grandfathered plan and distribute benefits in 2005 has not been extended into 2006.

C. More Guidance on Material Modifications

Amounts deferred and vested before 2005 are not subject to section 409A unless the plan under which the compensation is deferred is "materially modified" on or after October 3, 2004. Generally, a plan is materially modified if a benefit or right existing as of October 3, 2004 is enhanced or a new benefit or right is added. Notice 2005-1 provides limited guidance on what is and is not a material modification.

The regulations describe certain additional changes that will not result in material modification, including the establishment of a rabbi trust, and the addition of notional investment measures based on a "reasonable rate of interest." In addition, a plan amendment which could be considered a material modification may be rescinded within the year that it is made and will not be considered a material modification as long as no participant either received an additional benefit or otherwise took advantage of the provisions added by the amendment.

D. Calculating Grandfathered Amounts

The regulations slightly liberalize the rules under Notice 2005-1 for determining the grandfathered amount under a defined benefit SERP. In addition, although severance plans are now considered a separate category of deferred compensation plans for purposes of applying the 409A rules, the regulations do not detail how to calculate the grandfathered amounts under a severance plan in existence on December 31, 2004. The preamble to the regulations states that the principles used for calculating grandfathered amounts under account balance or non-account balance plans should be applied depending on the structure of the severance plan.

II. Scope of Section 409A

Generally, the new rules under section 409A apply to amounts deferred after 2004 under plans that provide for the "deferral of compensation." The proposed regulations continue to provide that, in general, a deferral of compensation occurs if an employee (or other service provider) has a legally binding right during a year to receive compensation that has not been actually or constructively received and that is payable in a later year. Nevertheless, the regulations exclude from coverage under section 409A many arrangements that provide for deferred compensation under this definition.

A. "Short-Term Deferral" Exemption Made Permanent

The Notice provided a temporary exemption from section 409A for arrangements that fit within a "short-term deferral" exemption. Specifically, the Notice provided that a deferral of compensation does not occur under a plan if – absent an election to otherwise defer a payment to a later period – the terms of the plan at all times require payment, and an amount is actually or constructively received by an employee by the later of:

- The date that is 2½ months after the end of the employee's taxable year in which the amount is no longer subject to a substantial risk of forfeiture; or

- The date that is 2½ months after the end of the employer's taxable year in which the amount is no longer subject to a substantial risk of forfeiture.

The regulations make the short-term deferral exemption permanent and provide examples relating to the application of the 2-1/2 month rule. The regulations also allow payments to be made after the 2-1/2 month period has ended if the reason for such delay is due to unforeseeable administrative or solvency issues. It is not necessary for the plan document to expressly state that the payment is to be made within the 2-1/2 month period, as long as the payment is actually made within that 2-1/2 month period. However, if the payment is not made within the 2-1/2 month period (and such delay was not the result of unforeseeable administrative or solvency issues), there will be an automatic violation of section 409A.

B. Stock Option and SAR Exception Expanded

Consistent with the legislative history and the Notice, the regulations provide generally that a nonqualified stock option is not subject to section 409A provided (1) the option is granted for not less than the fair market value of the underlying stock at the date of grant, (2) the option is taxable under Code section 83, and (3) the option does not include any feature for the deferral of compensation.

The Notice also provided that a stock appreciation right ("SAR") issued by a publicly traded company would not be subject to section 409A so long as (1) the SAR's exercise price is not less than the fair market value of the stock on the date the right is granted, (2) only shares of stock may be delivered upon exercise, and (3) the right does not include any feature for the deferral of compensation. In other words, only "publicly-traded, stock-settled" SARs would have been exempt from section 409A.

The regulations expand this exemption to treat 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 private corporation (including certain equity appreciation rights issued by mutual insurance companies). Generally, the regulations provide that a SAR is not subject to section 409A provided (1) compensation from a SAR cannot be greater than the difference between the fair market value of the stock on the date of grant and the fair market value of the stock on the date of exercise, (2) the SAR's exercise price may never be less than the fair market value of the underlying stock on the date of grant, and (3) the SAR does not include any feature for the deferral of compensation. The regulations also add a requirement (for both options and SARs) that the number of shares covered by the grant be fixed on the grant date.

Additional important guidance under the stock option and SAR exception is summarized below:

- **Awards Must be Based on Service Recipient Stock.** The regulations contain additional guidance that defines the types and classes of stock – defined in the regulations as "service recipient stock" – that are eligible for the exemptions for stock options and SARs (collectively referred to in the regulations as "stock rights"). Service recipient stock includes only common stock tradable on an established securities market, or if there is no such stock, that class of common stock that has the greatest aggregate value of any class of common stock issued and outstanding (or common stock with substantially similar rights to such class). Service recipient stock does not include preferred stock or stock that includes a mandatory repurchase obligation or a put or call right not based upon fair market value. The regulations contain rules defining "service recipient" for this purpose. These rules cover certain joint venture arrangements, but raise questions as to their applicability to situations where parent company stock rights are issued to employees of subsidiaries or other affiliates.

- **Determination of Fair Market Value.** The regulations provide considerable guidance with respect to the valuation of service recipient stock. In the case of a public corporation, fair market value may be determined in a variety of ways, including based on the closing price on the trading day before or the trading day of the grant. In the case of a private corporation, fair market value may be determined through the reasonable application of a reasonable valuation method, as determined based on the facts and circumstances and taking into account certain factors. The regulations provide safe harbor valuation methods under which the consistent use of such method is presumed to result in the fair market value of the stock. The safe harbor methods include (1) valuation by an independent appraisal that satisfies the requirements applicable to ESOPs, (2) formula-based valuations used as part of a nonlapse restriction as defined in the Code section 83 regulations if the method is used consistently for both compensatory and noncompensatory purposes in all transactions, and (3) a written report taking into account certain factors in the case of an illiquid stock of a start-up corporation. Special valuation rules apply in the case of illiquid stock of start-up companies.

- **Modifications of Stock Rights.** The regulations set forth detailed rules governing the types of modifications, extensions, or renewals of stock rights that will or will not result in treatment as a new grant or as evidencing an additional deferral feature. This is significant because treatment as a new grant could disqualify the stock right from the 409A exemption if the exercise price is less than the fair market value of the stock on the date of the change. If a change is treated as providing an additional deferral feature, the stock right would be subject to section 409A from the date of grant. Importantly, the regulations provide that an extension of the exercise period will not be treated as providing an additional deferral feature if extended to a date no later than the later of the 15th day of the third month following the date at which, or December 31 of the year in which, the right would otherwise have expired.

C. Severance Plan Exemption Expanded

Notice 2005-1 stated that a plan providing severance pay benefits that was (1) a collectively bargained plan or (2) a broad-based arrangement (i.e., the plan does not cover "key employees") would be exempt from section 409A during 2005. For purposes of this transition rule, amounts are considered severance pay if such amounts are only payable upon involuntary termination or the arrangement satisfies the DOL's severance pay safe harbor regulation (29 CFR § 2510.3-2(b)).

The regulations provide a much broader set of exceptions for severance plans than was anticipated. The exceptions are summarized below:

- **Two Times Pay Cap.** A severance arrangement that provides for payments upon involuntary termination of employment – or pursuant to a "window program" (generally limited to one year) – may be exempt if the entire amount payable under the arrangement does not exceed two times the employee's annual compensation or, if less, two times the maximum amount of compensation that can be taken into account under a qualified plan under Code section 401(a)(17) ($210,000 for 2005). In addition, the payments must be made no later than the end of the second year following the year in which the termination of employment occurs. This means that generally there can be a continuation of an employee's salary (not to exceed the Code section 401(a)(17) limit) for a period of two years – which generally follows the DOL's severance pay safe harbor regulation.

- **Use of Short-term Deferral Exception.** Even if a severance plan does not fit within the enumerated exceptions, it may still fit within the short-term deferral exception. The preamble states that amounts payable upon an involuntary termination of employment will be considered subject to a substantial risk of forfeiture. Thus, if all severance payments are made within 2½ months after the year in which an involuntary termination occurs, the short-term deferral exception should apply. If a plan provides for severance upon a voluntary termination (i.e., for "good reason"), the preamble implies that the short-term deferral exception will not apply, but the IRS specifically requests comments on this issue.

- **Post-Employment Reimbursements.** Certain reimbursements payable for a limited time after a termination of employment (i.e., by the end of the second calendar year after the calendar year of termination) such as business expense reimbursements, medical expenses, the provision of in-kind benefits (such as office space), moving and relocation payments, and outplacement expenses will not be considered deferred compensation under section 409A. Other de minimis payments or reimbursements of less than $5,000 in the aggregate shall also not be considered deferred compensation. The implication of this rule, of course, is that the continued provision of these types of benefits after the permitted period may well involve deferred compensation unless expressly excluded.

- **Union Plans.** Generally, separation pay upon involuntary termination of employment or pursuant to a window program that is provided for under a collectively bargained plan is not subject to section 409A if the collective bargaining agreement is bona fide.

D. Foreign Plan Exemptions

As anticipated, the regulations do not provide a blanket exclusion from section 409A for all foreign and multi-national arrangements. However, they do provide a number of important exceptions and transition relief that address many of the concerns raised by commentators. The overall approach can be summarized as follows.

- **Non-Resident Aliens.** Non-resident aliens are generally subject to section 409A for deferred compensation earned for services performed in the U.S. that is not otherwise exempt from Federal income taxation under the Code or an applicable treaty. However, there are two exceptions: (1) U.S. compensation/services up to $10,000 for the year, and (2) U.S. compensation deferred under a broad-based foreign retirement plan.

- **U.S. Citizens.** U.S. citizens are subject to worldwide taxation. Therefore, all compensation (regardless of source) deferred under a nonqualified deferred compensation plan is subject to section 409A, except: (1) unused section 911 limit (limited exclusion for foreign earned income), (2) any amount not subject to taxation as a result of a treaty, (3) nonelective deferrals of foreign earned income under a broad-based foreign retirement plan (up to Code section 415 limits), (4) contributions to a funded foreign arrangement subject to taxation under Code section 402(b), and (5) totalization and tax equalization payments.

- **U.S. Residents.** Resident aliens are also subject to worldwide taxation. Therefore, all compensation (regardless of source) deferred under a nonqualified deferred compensation plan is subject to section 409A, except as generally noted above for U.S. citizens. Also, there are two special provisions for resident aliens intended to prevent undue hardship: (1) amounts previously deferred and vested while working abroad as a non-resident alien are exempt, and (2) in the year the individual becomes a resident alien, special transition relief applies.

E. Split Dollar Life Insurance

The regulations do not provide a blanket exemption for split dollar life insurance arrangements as some had hoped. The preamble to the regulations notes that such arrangements may fit within the "death benefit plan" exemption from coverage, and that arrangements treated as loans under the IRS's split dollar regulations do not generally involve a deferral of compensation within the meaning of section 409A. However, post-409A benefits under certain grandfathered plans and arrangements such as those using the "endorsement" method, may fall within the scope of section 409A. Comments are requested on the need for modifications in the split dollar grandfather rules to accommodate 409A-related changes.

F. Interaction With Section 457(f)

The preamble discusses some aspects of the regulations' impact on 457(f) plans. As a general matter, nonqualified deferred compensation plans of tax-exempt and governmental employers that do not satisfy sections 457(b) or 415(m) are taxable under section 457(f) when the amounts are no longer subject to a substantial risk of forfeiture.

Initially, the regulations state that they are guidance only with respect to Code section 409A, and not 457(f). Accordingly, the preamble indicates that amounts may be treated as deferred compensation for purposes of section 409A even though they might be considered subject to a substantial risk of forfeiture for purpose of Code section 457(f), including mutual fund stock options and elective deferrals. Noncompete agreements, consulting agreements and "rolling risks of forfeiture"– all of which in the view of some might constitute a substantial risk of forfeiture for section 457(f) purposes – would not preclude the treatment of amounts subject to such conditions from being deferred compensation subject to section 409A.

On the other hand, the preamble indicates that governmental and tax exempt entities can rely on the definitions of bona fide vacation leave, sick pay, compensatory time, disability pay and death benefit plans under section 457(e)(11) for purposes of section 409A and the regulations. Because section 409A does not exclude severance pay (which is exempt from section 457) from the definition of deferred compensation, a severance pay plan of a tax exempt or governmental employer must meet one of the exemptions for severance pay plans set forth in the regulations and discussed herein, or comply with section 409A (which it may be possible to do by removing discretion as to the time and form of payout – a course employers may well want to consider).

Mutual fund stock options – at one time touted as a way around section 457 – were essentially shut down for 457 purposes for options issued after May 8, 2002.

Section 409A would apply to grandfathered plans (under 457 regulations), making them problematic, because the 409A exceptions for options only apply to stock of the service recipient (the employer). However, such options may be grandfathered from 409A if the option was exercisable, and any stock that would have been received would have been vested, on December 31, 2004 (if the option is not materially modified after October 3, 2004).

The regulations do not directly address some other 457(f) issues such as (1) whether a plan may follow the 1-year in advance/5 year of deferral rule as a "rolling risk of forfeiture" for 457(f) purposes, or (2) whether a 457(f) plan that otherwise complies with section 409A – for example, by tying payout to a fixed date or schedule rather than upon vesting – can defer taxation under 457(f) with a rolling risk of forfeiture prior to payout. Informally, the IRS has been skeptical of whether rolling risks of forfeiture are substantial for 457(f) purposes for some time in any event.

The regulations carry over the provision in the Notice that a permitted acceleration event is to pay tax – federal, state, local or foreign - upon the falling off of a substantial risk of forfeiture under a 457(f) plan. As before, this is limited to the amount of tax that would have been withheld and remitted by the employer had the includible amounts been paid.

III. Deferral Election Rules

Section 409A provides special rules for initial deferral elections in the case of new participants and performance-based compensation. The IRS addresses these special rules in the regulations and provides special rules for initial deferral elections in various other contexts.

A. General Rules

Generally, an initial election to defer compensation must be made by the close of the year preceding the year in which compensation subject to the deferral election is earned. The election must include the time and form of payment and must be irrevocable as of the deadline for making the election. Even if there is no election (e.g., as with a SERP), the plan must satisfy the latter requirements.

Once made, a deferral election may remain in place from year to year as long as it becomes irrevocable by the date (e.g., December 31) an affirmative deferral election would have been required to be made.

B. Performance-Based Compensation

An election to defer "performance-based compensation" with a performance period of at least 12 months may be made as late as six months before the end of the period, provided payment of a readily ascertainable amount of compensation is not substantially certain at the time of election. The regulations define the term "performance-based compensation" in a manner similar to the definition under the Notice. Thus, compensation which is contingent on the satisfaction of pre-established organizational or individual performance criteria (including subjective performance criteria) will qualify as performance-based. However, the regulations require the performance criteria to be established in writing within the first 90 days of the performance period, and that the achievement of the criteria must be substantially uncertain at the time the criteria are established.

In a major change from Notice 2005-1, the regulations provide that options and SARs issued at fair market value may qualify as performance-based compensation. However, as the preamble points out, permitting deferrals of such options and SARs will subject them to coverage under section 409A, and they likely will not comply with the distribution rules unless they contain a fixed payment date.

C. 30-Day Rule For New Participants

Generally, an initial election to defer compensation may be made within 30 days after the date an employee first becomes eligible to participate in a plan. As feared, the regulations make clear that an employee will only be treated as a new participant in a plan if he has not previously participated in any plan of a similar type (e.g., any account balance plan) maintained by the employer.

A new participant election under this rule may only apply to compensation earned after the election is made. The regulations address how this rule would apply to a new participant's election to defer a bonus earned during the year the election is made.

D. Stock Awards and Other Ad Hoc Grants

The regulations provide a 30-day period for elections to defer certain grants of compensation in some circumstances (e.g., ad hoc grants in the middle of the year). (It is unclear whether the grant must be "unforeseeable.") Specifically, where a grant of compensation is subject to a forfeiture condition requiring the continued performance of services for a period of at least 12 months, an election may be made no later than 30 days after the date of grant, provided the election is also made at least 12 months in advance of the vesting date. This rule should accommodate deferrals of restricted stock unit awards that are subject to a vesting requirement of at least 12 months.

E. Short-Term Deferrals

An initial election to defer compensation that would otherwise fit within the short-term deferral exception generally will be governed by the subsequent election rules. For purposes of applying the subsequent election rules, the date on which the substantial risk of forfeiture lapses will be treated as the original time of payment.

F. <u>401(k) Mirror and Wrap Around Plans</u>

The regulations provide relief for certain 401(k) "wrap around" plans. Essentially, the regulations provide that participant deferral elections under a 401(k) plan may result in increases or decreases in amounts deferred (and matching contributions) under a related nonqualified plan without violating section 409A, as long as the increases and decreases on the nonqualified side are limited to the 401(k) deferral limits. In the past, IRS personnel had expressed concerns that such elections could result in "late" deferral elections or impermissible accelerations of payment.

It is important to note that the above guidance will not provide relief for the more typical nonqualified "401(k) mirror" plan, where the employee's deferral election applies to amounts in excess of the qualified plan contribution or compensation limits (<u>i.e.</u>, not only the discrimination tests). Such deferrals may no longer "float" automatically with changes made by the employee under the qualified plan (although the election may remain in effect from year-to-year without affirmative action by the employee).

G. <u>Fiscal Year Compensation</u>

As contemplated by the legislative history of section 409A, the regulations provide a special rule for initial elections to defer fiscal year compensation. "Fiscal year compensation" is defined as compensation relating to a period of service coextensive with one or more consecutive fiscal years of the employer. The deadline for an election to defer such compensation is the beginning of the first fiscal year in which any of the relevant services are performed. Thus, if an employer is to pay an employee a bonus based on performance during the employer's July 1, 2006 to June 30, 2007 fiscal year, the employee may make an election to defer the bonus at any time prior to July 1, 2006. As the preamble makes clear, other forms of compensation paid by a fiscal year employer that do not meet these rules (<u>e.g.</u>, salary) are not eligible for this special rule.

H. <u>Commissions</u>

In general, if an employee's right to commission compensation is contingent on a customer making a payment (<u>e.g.</u>, to renew the insurance policy), an initial election to defer the commission compensation need only be made prior to the year in which the customer renders payment.

I. <u>Separation Pay</u>

An initial election to defer severance payable as a result of an involuntary separation from service and that is the subject of bona fide, arm's length negotiations may be made at any time prior to the employee's obtaining a legally binding right to the payment. With respect to severance payable under a "window program," an initial deferral election may similarly be made at any time prior to the time participation in the window program becomes irrevocable. These rules are quite helpful and reflect approaches many thought might work under general constructive receipt principles.

IV. Distribution Rules

The regulations incorporate the statutory requirement that payments be made no earlier than a fixed date or under a fixed schedule, or upon any of five events: (1) a separation from service, (2) death, (3) disability, (4) change in control, or (5) unforeseeable emergency.

A. Objective Payment Date Required

For a payment to be made as a result of one of the above 5 events, the plan must designate an objectively determinable date following the event upon which the distribution is to be made. For example, a plan could provide for payments to be made as of the January 1 following a separation from service, or three months after disability. A statement that payments will be made as soon as practicable after a triggering event would likely violate this requirement. A payment will be treated as made on the designated distribution date if made by the later of (1) the end of the year containing the designated date, or (2) the 15th day of the third month following the designated date.

The plan may designate an objectively determinable date by simply specifying the year or years in which the distributions are scheduled to be made, without specifying a particular date within the year. However, for plans that only designate the year of distribution, the first distribution is deemed to be scheduled for January 1 of such year for purposes of applying the subsequent election rules.

B. Multiple Payment Events Permitted

As expected, the regulations permit a plan to provide for distributions upon the earlier of, or the later of, two or more specified permissible events. Furthermore, the plan may provide for different forms of distribution depending on the actual triggering event. For example, a plan may provide that distributions will be made on the later of the date a participant (1) attains age 55, or (2) separates from service. Additionally, the plan could provide that the participant will receive a lump sump payment if distribution is triggered by a separation from service, but will receive a series of installment payments if distribution is triggered by the attainment of age 55.

Likewise, a plan may allow for an alternate distribution schedule if a specific triggering event occurs on or before one (but not more than one) specified date. For example, a plan could provide for a lump sum upon a separation from service before age 50, and installments upon a separation from service on or after age 50.

C. Certain Delayed Distributions Allowed

The regulations provide relief from the distribution timing rules if payments may not be made for reasons beyond the employer's control, or if payments would jeopardize the employer's solvency. The rules also give the employer the ability to delay distributions if (1) the deduction associated with the distribution would be limited by Code section 162(m), or (2) the distribution would violate securities laws, loan covenants or similar contractual requirements. Finally, the regulations provide relief for delayed payments due to an employer's refusal to pay benefits and for disputed payments in "bona fide" situations based on the facts and circumstances.

D. Distributions on "Separation From Service"

Distributions may be made under section 409A when a participant "separates from service." The regulations provide considerable guidance on when employees and independent contractors will be treated as separating from service for purposes of section 409A.

Generally, an employee experiences a separation from service if the employee dies, retires, or otherwise has a termination of employment. The employment relationship is treated as continuing intact while the participant is on certain leaves (generally limited to 6 months). Additional rules address how an employee's continuing services for an employer will impact the determination of whether a termination has occurred. An independent contractor is considered to have a separation from service upon the good-faith and complete termination of all contractual relationships under which services are performed for the service recipient.

E. "Key Employee" Rules

Distributions made to a "specified employee" as a result of a separation from service may not be made for at least six months after the separation. The term "specified employee" generally means a "key employee" (as defined in Code section 416(i)) of a publicly-traded company.

The regulations do not provide safe harbor definitions of "officer" to be used in determining "key employees" as requested by some commentators. However, they do attempt to facilitate administration by providing that the identification of key employees is based on a one year look-back period ending on an identification date that may be selected by the employer (e.g., the last day of the plan year). An individual who is a key employee at any time during the look-back period is considered a key employee for the 12-month period commencing on the first day of the 4th month following the identification date. For example, if a plan consistently uses September 30 as its identification date, any employee who is a key employee between October 1, 2006 and September 30, 2007, will be a specified employee and subject to the six-month rule for all of 2008. The regulations also provide rules for determining key employees after a spin-off or a merger.

A plan must also address how the six-month delay will be implemented. Unfortunately, a blanket exception for long-term installments or annuity payments was not provided. However, scheduled installment or annuity payments may be accumulated for six months and paid in a lump sum in the seventh month after separation, each payment may be delayed for six months, or the entire stream of scheduled payments may commence on the seventh month.

The regulations also provide that the six-month delay does not apply to distributions permissibly accelerated as a result of: (1) a domestic relations order, (2) the payment of employment taxes, or (3) a certificate of divestiture under federal ethics rules.

F. Distribution Triggered by Vesting Event

The regulations provide that a plan may provide, at the time of the deferral, that an amount that is subject to a substantial risk of forfeiture will commence to be paid at a date that is objectively determinable based on the lapsing of the substantial risk of forfeiture. For example, if payments under a plan are contingent on the consummation of an IPO and that constitutes a substantial risk of forfeiture, a fixed schedule of payments may be triggered by the occurrence of the IPO.

G. Distributions on Change in Control

The rules regarding a distribution upon a change in control of a corporation remain substantially unchanged from Notice 2005-1. However, the IRS indicates in the preamble that it intends to issue regulations that will allow payments to be made upon a change in control of a partnership. Until further guidance is issued, the section 409A rules regarding permissible distributions on a change in control of a corporation may be applied by analogy to partnerships.

H. "Subsequent Election" Rules

Section 409A provides that a participant may make an election to change the time or form of a distribution after an amount has been deferred only if certain conditions are satisfied. Generally, these "subsequent elections" may not take effect for 12 months and must provide for a new distribution date that is at least 5 years after the date the distribution would have otherwise been made.

The regulations provide significantly more flexibility than expected with respect to "subsequent elections." The rules are complex and will call for changes in most 409A plans. We highlight some of the more important issues below.

- **Permitted Acceleration to Lump Sum.** Even though a change in the form of a distribution may result in a more rapid schedule for payments, the change will not constitute an impermissible acceleration of a distribution if the other timing rules are followed. Thus, a change may be made from an annuity form to a lump sum, provided the lump sum is elected at least 12 months before, and is paid at least five years after, the annuity payments were scheduled to begin.

- **Changing Annuity Forms Not Subject to Rules.** A change from one life annuity form to another actuarially equivalent life annuity form before any payments have been made will not be subject to the subsequent election rules.

- **Nonelective Plans.** The regulations require that when an individual attains a legally binding right to an amount under a nonelective plan (e.g., a SERP), the time and form of payment for the amount must be specified. This specification of time and form of payment under the plan will be treated as an initial deferral election under the rules. Thus, any change to the time or form after that time will be subject to the subsequent election rules.

- **Separate Application of Rules to Each Payment Trigger.** In the case of a plan that provides for multiple distribution events, the subsequent election rules apply to each distribution event separately. For example, if a plan provides for a lump sum distribution upon the earlier of attaining age 65 or a separation from service, a participant may elect in advance to delay the distribution triggered by attaining age 65 in accordance with the subsequent election rules (i.e., to at least age 70), while maintaining the right to receive a distribution immediately upon a separation from service.

- **Separate Application of Rules to Payments in a Series.** The regulations allow a plan to treat installment payments – or other payments scheduled to be made over a period of several years – as separate payments for purposes of the subsequent election rules. This fairly liberal (though administratively complex) approach does not apply to life annuity payments (which are always treated as a single payment).

I. Prohibition on Acceleration of Distributions

Generally, section 409A prohibits an acceleration of payment under a nonqualified deferred compensation plan. Notice 2005-1 enumerates several exceptions to this rule. The regulations provide the following additional helpful exceptions –

- **Intervening Event.** A plan may provide that an intervening distributable event (e.g., death) may override an existing distribution schedule already in pay status. Thus, a plan could provide that a participant's beneficiary will receive a lump sum distribution following the participant's death, even if installment payments to the participant have begun.

- **<u>Cancellation of Election Due to Hardship</u>.** If a participant obtains a distribution under a nonqualified plan due to an unforeseeable emergency or a hardship distribution under a tax-qualified plan, a plan may permit the cancellation of a participant's deferral election.

- **<u>Coordination With Qualified Plans</u>.** The rules provide that (1) an amendment of a qualified plan to increase or decrease benefits, (2) an amendment to add, remove or adopt subsidized or ancillary benefits or (3) a participant election of a subsidized or ancillary benefit, will not be treated as a deferral election or an impermissible acceleration, even if they change the amount of nonqualified plan benefits.

- **<u>409A Violation</u>.** A plan may provide for an accelerated distribution to pay the amount a participant must include in income as a result of a section 409A violation.

J. <u>Distributions on Plan Termination</u>

The regulations permit an employer to terminate a plan and distribute benefits without violating the prohibition on acceleration of payments in limited circumstances. First, an employer may terminate a plan and distribute benefits if:

- All plans of the same type maintained by the employer (<u>e.g.</u>, all account balance plans) are terminated with respect to all participants;

- No payments are made within 12 months of the plan termination (other than those that would have been paid absent the termination);

- All payments are made within 24 months of the plan termination; and

- The employer does not adopt a plan of the same type (<u>e.g.</u>, a new account balance plan) for a period of 5 years following the date of plan termination.

Second, a plan may be terminated in connection with a change in control, corporate liquidation, or with the approval of a bankruptcy court. The IRS notes in the preamble that it is considering further guidance that would permit plan terminations in additional circumstances.

V. <u>Comments Requested/Additional Guidance Expected</u>

The IRS requests that comments on the regulations be submitted by January 4, 2006. A public hearing has been scheduled for January 25, 2006.

As expected, the proposed regulations focus on guidance employers need to amend their nonqualified plan documents. Thus, the IRS did not address the funding restrictions under section 409A, the Form W-2 reporting requirements, or the penalty provisions. The IRS is attempting to provide guidance on these and other issues by the end of 2005.

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Please call one of the following, or the firm attorney you regularly contact, if you have any questions about the new regulations or their impact on your executive compensation arrangements.

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