



Proposed Section 409A Regulations Provide Increased Flexibility for Nonqualified Deferred Compensation Plans

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On September 29, 2005, the Internal Revenue Service (IRS) publicly issued its long-awaited proposed regulations under section 409A of the Internal Revenue Code. Section 409A, which was enacted as part of the American Jobs Creation Act of 2004, established new procedural and substantive requirements for nonqualified deferred compensation plans and arrangements. The proposed regulations incorporate most of the prior guidance provided in IRS Notice 2005-1, issued on December 20, 2004, but with certain clarifications and modifications in response to public comments. In addition, the proposed regulations provide initial guidance on several subjects that were not addressed in Notice 2005-1, including, for example, rules respecting initial deferral elections, time and form of payment and subsequent elections to change time and form of payment. Generally, the proposed regulations provide service recipients (*i.e.*, plan sponsors) with a welcomed degree of flexibility in designing deferred compensation plans and arrangements that will comply with section 409A, although several traps for the unwary do remain.

Effective Date of Proposed Regulation and Good Faith Compliance

Notice 2005-1 provided that to the extent section 409A applies to a plan adopted any time before December 31, 2005 (*i.e.*, a plan that is not grandfathered), the plan will not be treated as violating section 409A so long as the plan is operated in good faith compliance with section 409A and Notice 2005-1 during all of 2005 and the plan is amended before December 31, 2005 to conform with the applicable requirements of section 409A. The proposed regulations include a proposed effective date for taxable years on or after January 1, 2007. As a result, the good faith compliance period for operational compliance has been extended for one additional year to December 31, 2006, and the deadline for amending documents to comply with the rules has been extended until December 31, 2006. Compliance

with the proposed regulations is deemed to be good faith compliance.

Transition Rules

Initial Deferral Elections. Notice 2005-1 provided a special timing rule for initial elections to defer amounts attributable to services performed before December 31, 2005. The transition rule allowed the initial deferral election to be made on or before March 15, 2005 if certain requirements were met. The proposed regulations do not extend this relief.

New Distribution Elections. Notice 2005-1 provided that a plan sponsor may amend the plan to provide for new distribution elections for amounts that were previously deferred. Under Notice 2005-1 the new distribution election is not subject to section 409A's restrictions on changes in the form and timing of a payment

provided that the election and plan amendment are each in place on or before December 31, 2005. The proposed regulations extend through December 31, 2006, the period during which a change in a payment election may be made, provided that during 2006 (i) a change may not be made with respect to payments the service provider (*i.e.*, the employee) would otherwise receive in 2006 and (ii) the change in election may not cause payments to be made in 2006.

Termination of Participation or Deferrals. Notice 2005-1 provided that a plan adopted before December 31,

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2005 may be amended to allow a participant, at any time during 2005, to either terminate participation in the plan or cancel a deferral election and receive a distribution of the deferred amounts in 2005 (or, if later, the year in which the amount is earned and vested), provided that (i) the amendment is in place on or before December 31, 2005 and (ii) the full amount of the distribution is included in the participant's income in 2005 (or, if later, the year in which the amount is earned and vested). The proposed regulations do not extend this transition period.

- *Planning Note:* Thus, plan terminations or elections to cancel deferrals and opt out of plan participation must still be completed, and accounts must be distributed, before the end of 2005 in order to avoid the need to comply with section 409A going forward.

The proposed regulations do, however, clarify that if no plan amendment is necessary for the participant to terminate participation in the plan or cancel a deferral election, the transition relief is still available so long as the amount subject to the cancellation or termination is includible in the participant's income for 2005 (or, if later, the year in which the amount is earned and vested). The proposed regulations also provide that the exercise of a stock option, stock appreciation right or similar equity appreciation right that is covered by section 409A (e.g., a stock option issued at a discount to fair market value), will be treated as a cancellation of a deferral under the transition relief of Notice 2005-1.

Termination of Grandfathered Plans. Notice 2005-1 permitted plan sponsors to amend a grandfathered deferred compensation plan to terminate the plan and distribute the amounts previously deferred on or prior to December 31, 2005, without having the amendment treated as a "material modification" that caused the grandfathered deferrals to become subject to section 409A. To qualify for this relief, all amounts deferred under the plan must be included in participants' income in taxable year in which the termination occurs. The proposed regulations do **not** extend this transition relief beyond December 31, 2005. The proposed regulations clarify that an amendment that gives a participant the right to terminate participation in the plan or to continue to defer amounts under the plan would not be eligible for the transition relief and would constitute a "material modification." Any distribution prior to December 31, 2005 pursuant to such an election would still be permissible and exempt from section 409A, but amounts that are not distributed and continue to be deferred would become subject to section 409A.

Distributions Linked to Qualified Plans. Notice 2005-1 provided that distributions made on or before December 31, 2005 under a nonqualified deferred compensation plan that are linked to distribution elections made under a qualified plan will not violate section 409A, provided that the linked distributions are made in accordance with the distribution provisions of the nonqualified deferred compensation plan in effect as of October 3, 2004. The proposed regulation extend through December 31, 2006 the period during which the timing and form of payment under a nonqualified plan may be linked to the qualified plan, provided that the determination of the timing and form of payment is made under the terms of the nonqualified plan as in effect as of October 3, 2004.

Nonqualified Deferred Compensation Subject to Section 409A

The proposed regulations confirm that deferred compensation subject to section 409A generally includes a legally binding right acquired during a taxable year to compensation that is payable in a later year.

Negative Discretion. Consistent with Notice 2005-1, the proposed regulations provide that, for purposes of determining whether there has been a deferral of compensation, no legally binding right to compensation exists if the compensation may be unilaterally reduced or eliminated after the services creating the right have been performed. The proposed regulations clarify, however, that negative discretion will **not** be recognized if it lacks substantive significance or is available or exercisable only upon a condition. Negative discretion will also be ignored where the service provider has certain influence over the person who exercises the discretion.

Short-Term Deferrals. The proposed regulations incorporate the exception from section 409A coverage for short-term deferrals, i.e., deferrals no longer than 2½ months after the later of the end of the service provider's or service recipient's taxable year, but provide increased flexibility and some protection from inadvertent violations by permitting extensions of the 2½-month short-term deferral period where it is either administratively impracticable to make the payment by the 2½-month deadline or where making the payment by the deadline would jeopardize the solvency of the service recipient. Extension of the 2½-month short-term deferral period is not available, however, if the circumstances causing the payment delay were foreseeable at the time the legally binding right to the compensation arose or the delay is caused by the service provider or someone controlled by the service provider.

- *Planning Note:* Although there is no requirement that a plan document specify in writing that payments must be made by the short-term deferral deadline in order to avoid application of section 409A (so long as the payment is actually made by the deadline), plan sponsors should consider including a date or year of payment in the written plan document, even if it is intended that the payment will be made within the short-term deferral period. For example, if the plan document does not specify that a particular payment must be made within the 2½-month short-term deferral period, failure to actually make the payment by the deadline will result in the payment becoming subject to section 409A, with an automatic violation of section 409A due to a failure to specify a payment date. In contrast, if the plan provides that payment must be made by the end of the 2½-month short-term deferral period, and the payment subsequently becomes subject to section 409A due to a failure to make the payment within the short-term deferral period, then the payment will comply with section 409A so long as it is made by the end of the calendar year within which the short-term deferral period ends.

Equity Compensation. In response to comments to Notice 2005-1, the proposed regulations conform the treatment of stock appreciation rights (SARs) to that of nonqualified stock options and extend the exception for SARs to grants by private companies and grants that are settled in cash. Also, the proposed regulations provide detailed rules regarding, among other things, the conditions for the exception for stock options and SARs, including a requirement for the reasonable valuation of service recipient stock for purposes of determining fair market value and the circumstances under which the modification of a stock option or SAR will be deemed to result in a new grant. A more detailed discussion of the equity compensation issues addressed in the proposed regulations is contained in the article “*Stock Compensation Provisions in Proposed Section 409A Regulations*” elsewhere in this bulletin.

Severance Pay. The proposed regulations confirm that severance plans, which are referred to as “separation pay arrangements” in the proposed regulations, are subject to section 409A, whether the plans cover any key employees or provide for payments only upon an involuntary separation from service. The proposed regulations, however, specifically exclude from section 409A coverage arrangements that provide for separation

pay upon either an actual involuntary separation from service or pursuant to a voluntary window program if either of the following conditions are met:

- The arrangement is contained in a collective bargaining agreement and was the subject of arm’s-length labor negotiations, or
- The entire amount of payment under the arrangement does not exceed two times the lesser of the service provider’s prior year’s annual compensation or the limit on annual compensation that may be taken into account for qualified plan purposes under section 401(a)(17) for the prior year (*i.e.*, \$210,000 for 2005, increasing to \$220,000 for 2006) and all payments are made not later than December 31st of the second calendar year following the year in which the service provider separates from service.

This exclusion effectively keeps most broad-based severance plans outside the reach of section 409A.

The proposed regulations also exclude from section 409A coverage certain reimbursement arrangements related to a termination of service, *e.g.*, reasonable outplacement and moving expenses, continued medical coverage, *etc.*, but only to the extent that the arrangement covers expenses incurred and reimbursed before the end of the second calendar year following the calendar year in which termination occurs. Reimbursement of *de minimis* expenses, *i.e.*, not exceeding \$5,000 is also exempted.

- *Caution:* The exclusions for separation pay do not apply to the extent that the separation pay substitutes for or replaces amounts that would otherwise be subject to section 409A. For example, a right to separation pay obtained in exchange for the relinquishment of deferred compensation rights will not be excluded from section 409A coverage to the extent that the rights relinquished were subject to section 409A.
- *Planning Note:* So long as separation payments will be made only upon an involuntary separation from service, the payment right will be viewed as a nonvested right. Accordingly, where the separation pay is not excluded from section 409A coverage, *e.g.*, because it provides for payments greater than two times annual compensation, the arrangement can still be structured to avoid application of section 409A by meeting requirements for short-term deferral, *i.e.*, completing all payments by end of the short-term deferral period.

Initial Deferral Election Rules

General Rule. Section 409A and the proposed regulations provide generally that a service provider must make a deferral election, including an election as to the time and form of payment, in the taxable year before the year in which the services giving rise to the compensation are performed.

Evergreen Elections. The regulations confirm that an evergreen election, *i.e.*, a deferral election that remains in place for all subsequent years unless and until the service provider elects otherwise, can be structured to satisfy the initial deferral election requirements, provided that the election becomes irrevocable with respect to a subsequent year not later than the election deadline for such subsequent year.

Nonelective Arrangements. The regulations clarify that, in order to avoid application of the initial deferral election rules for nonelective arrangements, a plan may not provide a service provider or service recipient with any discretion as to the amount of the deferral and the time and form of payment, but must set the amount of the deferral and the time and form of payment not later than the time the service provider would have been required to make an irrevocable deferral election had the arrangement been an elective arrangement (*e.g.*, prior to the end of the taxable year preceding the service year).

First-Year of Eligibility. Section 409A and the proposed regulations permit initial deferral elections to be made within 30 days after a service provider first becomes eligible to participate in the plan, but only with respect to compensation paid for services performed subsequent to the election. The proposed regulations clarify that, for compensation based on a specified performance period (for example, an annual bonus), where a deferral is made in the first year of eligibility but after the beginning of the service period, the election is deemed to apply to compensation paid for service performed subsequent to the election if the election applies only to a prorated portion of the total compensation, based on the percentage of the service period remaining after the election is made. Also, the proposed regulations confirm that the plan aggregation rules apply in determining whether a service provider is newly eligible for participation.

- *Example:* An employee who already is eligible for a broad-based salary deferral account balance plan and who subsequently becomes eligible for a management account-balance plan due to a mid-year promotion will **not** be permitted to

utilize the first-year-of-eligibility rule to make a mid-year deferral under the management plan because the broad-based plan and management plan must be aggregated for this purpose.

Mid-Year Grants of Certain Forfeitable Rights. To accommodate service recipients that might make mid-year “ad hoc” grants of certain forfeitable rights (*e.g.*, restricted stock units) that were unforeseeable prior to the start of the year, the proposed regulations provide that where the mid-year grant is subject to a forfeiture condition requiring the continued performance of at least 12 months of services, the initial deferral election may be made not later than 30 days after the date of grant, provided that the election is made at least 12 months prior to the end of the service period.

Performance-Based Compensation. With respect to the deferral of “performance-based compensation” that is based on a performance period of at least 12 months, section 409A and the regulations permit the initial deferral election to be made not later than six months prior to the end of the applicable performance cycle, but only if at the time the deferral election is made, either the amount of the compensation is not readily ascertainable or the right to receive the compensation is not substantially certain. The proposed regulations confirm that, for this purpose, the performance criteria for performance-based compensation may be established up to 90 days after the commencement of the service period, provided that the outcome is not substantially certain at the time the criteria are established, and may include subjective criteria if certain conditions are met. Also, unlike the position taken in Notice 2005-1, the proposed regulations permit performance-based compensation to be based solely an increase in value of the service recipient or the service recipient’s stock.

Commissions. The proposed regulations treat a service provider as having performed the services that give rise to commissions during the service provider’s taxable year in which the customer pays for the goods or services that generated the commissions. Thus, the initial deferral election with respect to such commissions may be made not later than December 31 of the calendar year preceding the year in which the customer renders payment.

Separation Pay Arrangements. Where the separation pay arrangement is the result of an arm’s-length agreement negotiated at the time of an involuntary separation from service, the proposed regulations provide that the initial election as to the time and form of

payment may be made on or before the date the service provider obtains a legally binding right to payment.

Time and Form of Payment

General Rule. The proposed regulations incorporate the section 409A requirement that payments be made only at a fixed date or upon a fixed schedule, or upon any of five events: a separation from service, death, disability, a change in ownership or effective control of a corporation or an unforeseeable emergency. Where the payment is made upon the occurrence of one of the five events, the regulations require the plan to designate an objectively determinable date or year following the event upon which the payment is to be made, e.g., within 90 days after a change in control, or during the first calendar year following a separation from service.

Multiple Payment Events. The proposed regulations confirm that a plan may provide that payments be made upon the earlier of, or later of, two or more designated events or times, so long as each such event or time is otherwise permissible. Also, the proposed regulations provide that a different form of payment may be applied to each potential payment event.

Time Limit For Making Payments. Recognizing that it is not always administratively feasible to make a payment on the exact date designated in the plan, the proposed regulations provide that a payment is treated as made on the designated payment date if either the payment is actually made on such date or if it is made on or before the later of the end of the calendar year that includes the designated payment date or the 15th day of the third calendar month after the designated payment date. Also, if calculation of the payment amount is not administratively practicable due to event beyond the control of the service provider (or the service provider's estate), or if the service recipient lacks sufficient funds to make the payment on the designated date without jeopardizing its financial solvency, the payment will be treated as made on the designated date if it is made at any time during the first calendar year in which the payment becomes administratively practicable, or in which the service recipient has sufficient funds to make the payment without jeopardizing its financial solvency.

- *Note:* There seems to be an inconsistency between the rule stated in the actual text of the proposed regulations, which is described above, and the rule described in the preamble to the proposed regulations, which provides that a payment is timely if it is made by the later of the first date after the designated payment date that it is

administratively feasible to make the payment or the end of the calendar year containing the designated date. We assume that the rule described in the actual text of the proposed regulation will control.

Specified Time or Fixed Schedule. The proposed regulations permit a plan to specify simply the calendar year or years in which payments are scheduled to be made, without specifying the particular date within such year on which the payment will be made.

- *Planning Note:* If a plan simply designates a calendar year, instead of a specific date, for payments to be made or commence, the first payment will be deemed to be scheduled for January 1 of such year for purposes of the subsequent election rules described below, regardless of the date the payment will actually be made.

Separation from Service. The proposed regulations provide detailed guidance regarding the circumstances under which service providers, including employees and independent contractors, will be treated as separated from service for purposes of section 409A. The proposed regulations also include an "anti-abuse rule" whereby an employee who actually or purportedly continues as an employee, but is not intended to provide more than insignificant services to the employer, will be treated as having incurred a separation from service. A converse anti-abuse rule treats a former employee who continues to provide substantial services to his employer in a capacity other than as an employee (e.g., as a consultant or independent contractor) as not having incurred a separation from service. Also, the preamble to the proposed regulations clarifies that the "same desk rule" applicable to section 401(k) plans does not apply to section 409A.

- *Example:* A service provider who continues in the same job with a successor employer after the sale to the successor employer of substantially all of the assets of the original employer will be deemed to have incurred a separation from service from the original employer for purposes of section 409A.

Six-Month Payment Delay For Key Employees. The proposed regulations clarify that the identification of key employees for purposes of the rule requiring a six-month delay in payments to a key employee of a public company following a separation from service is based upon the 12-month period ending on the

identification date chosen by the service recipient, so that persons who meet the requirements of a “key employee” during such 12-month period will be considered to be key employees for purposes of the plan for the 12-month period beginning on the first day of the fourth month following the end of the 12-month period. The default identification date is December 31.

- *Planning Note:* A service recipient may choose an identification date other than December 31 so long as the same identification date is used for all its plans, and any change to the identification date may not be effective for a period of at least 12 months.
- *Planning Note:* A service recipient may draft its nonqualified deferred compensation plan to provide for a six month delay for all participants in order to avoid an annual determination of who would be a key employee.
- *Transition Rule:* The proposed regulations include a transition rule whereby any designation of an identification date made on or before December 31, 2006 may be applied to any separation from service occurring on or after January 1, 2005.

The plan document must describe the manner in which the six-month payment delay for key employees will be implemented. For example, the plan may provide that any payments to which a key employee would otherwise be entitled during the first six months following the separation from service are accumulated and paid on the first day of the seventh month with the seventh month’s payment. Alternatively, the plan may provide that each installment payment to key employees is delayed for a period of six months following separation from service.

- *Planning Note:* A plan of a publicly traded company may be amended to change the manner in which the delay may be implemented, but any such amendment may not be effective for at least 12 months. Private companies that become publicly traded companies are permitted to amend their plans immediately upon becoming a publicly traded company.

Disability. The proposed regulations permit a plan to provide that a service provider will be deemed disabled for purposes of section 409A if the Social Security Administration determines that the service provider is totally disabled.

Change in Effective Ownership or Control of a Corporation. The rules for determining whether there has been a change in effective ownership or control of a corporation contained in Notice 2005-1 are incorporated in the proposed regulations substantially unchanged.

- *Application of Change in Control Rules to Partnerships.* Although neither the statute nor legislative history permit a distribution upon a change in control of an entity other than a corporation, the IRS indicated that it plans to use its authority under section 409A(a)(3), which permits the Secretary of the Treasury to provide exceptions to section 409A’s anti-acceleration rules, to issue subsequent regulations that will allow acceleration of payments upon a change in the ownership of a partnership or in the ownership of a substantial portion of the assets of a partnership. In the meantime, the proposed regulations permit the rules regarding permissible distributions upon a change in control of a corporation to be applied by analogy to changes in control of a partnership.

Unforeseeable Emergency. The proposed regulations clarify the definition of “unforeseeable emergency” and permit a plan to provide that a deferral election terminates if a service provider obtains a payment upon an unforeseeable emergency, or if such termination is required in order for the service provider to be able to obtain a hardship distribution under a 401(k) plan.

- *Planning Note:* In such case, the deferral election must be terminated, not merely suspended. Thus, a subsequent deferral election made after such termination must satisfy the requirements of an initial deferral election.

Subsequent Changes to Time and Form of Payment

General Rule. Section 409A and the proposed regulations provide that if a plan permits subsequent elections to delay a payment or change the form of a payment, the plan must require that the following conditions be met with respect to any such subsequent election:

- The election must not take effect until at least 12 months after the date of the election;
- In the case of an election related to a payment other than on account of death, disability or unforeseeable emergency, the first payment

covered by the election must be deferred for a period of not less than five years from the date the payment was initially scheduled to be made; and

- In the case of an election related to a specified time or fixed schedule, the election must be made at least 12 months prior to the specified time or the date of the first scheduled payment.

Definition of Payment. The proposed regulations provide generally that each separately identified amount to which a service provider is entitled to payment under a plan on a determinable date is a separate payment. The proposed regulations, however, treat life annuities and installment payments as a single payment, payable on the date of the first scheduled payment, for purposes of the subsequent deferral rules. A plan may, however, provide that installment payments (but not life annuities) be treated as a series of separate payments, provided that such treatment is applied consistently for purposes of the subsequent deferral and anti-accelerations rules.

- *Example:* If a series of 10-year installment payments is treated as a single payment and the first installment is scheduled to be paid on January 1, 2010, then, consistent with the five-year additional deferral rule, a service provider may change the time and form of payment to a lump sum payable on January 1, 2015 (five years after the date of the first scheduled installment payment). Provided that the other conditions related to a change in the time and form of payment are met, the change will not be treated as an impermissible acceleration, even though the change resulted in a more rapid payment of the service provider's total account.

In contrast, if the plan provided that installment payments be treated as a series of separate payments, then the service provider could not change the time and form of payment to a lump sum payable on January 1, 2015 because the installments scheduled for 2011 through 2019 would not have been deferred for five additional years. Instead, in this case, the service provider may change the form of payment to a lump sum only if the lump sum payment is scheduled to be made on or after January 1, 2024 (five years after the date of the last scheduled installment payment).

- *Planning Note:* The proposed regulations include a transition rule whereby a plan adopted and effective before December 31, 2006 that does not designate whether installments will be treated as a single payment or a series of payments will

be treated as having made such designation as of the later of the plan's adoption or effective date, provided that the designation is made in writing before December 31, 2006. Such action is needed, however, only if the service recipient wishes to treat the installments as a series of separate payments, since the default is to treat the installments as a single payment.

Application to Multiple Payment Events. The proposed regulations provide that, if a plan permits payments on the earlier of, or later of, two or more designated events or times, the subsequent election rules apply separately to each such event or time.

- *Example:* Assume a service provider initially elected to receive either an annuity at age 65 or, if earlier, a lump sum at separation from service. If the plan provides for subsequent changes to the time and form of payment, the service provider may elect to delay the annuity payment to age 70 and still be entitled to a lump sum on separation from service, if earlier.

Other Provisions Pertaining to Payments

Permitted Payment Delays by Service Recipient. The proposed regulations permit a plan to provide that a service recipient will delay payment of deferred amounts where (i) the service recipient's tax deduction for the payment would be limited or eliminated by the application of section 162(m), (ii) the payment would violate applicable securities laws or (iii) the payment would violate loan covenants or other contractual terms to which the service recipient is party, where such a violation would result in material harm to the service recipient.

- *Planning Note:* Plans may be amended to add such a provision, provided that the amendment is not effective for at least 12 months.
- *Caution:* If a plan is amended to remove such a provision with respect to amounts previously deferred, the amendment will constitute an impermissible payment acceleration.

Permitted Accelerations

General. The proposed regulations incorporate all of the permissible accelerations described in Notice 2005-1, including accelerations (i) in connection with a qualified domestic relations order, (ii) to comply with a certificate of divestiture, (iii) to pay income taxes due upon a vesting event in a section 457(f) plan, (iv) of

de minimis payments or specified amounts and (v) to pay employment taxes on deferred compensation. The regulations also permit acceleration of payments under the circumstances described below.

Income Inclusion Upon Violation of Section 409A. The proposed regulations permit a plan to provide that payments to a service provider will be accelerated to the extent needed to pay the amount the service provider must include in income as a result of the plan failing to meet the requirements of section 409A.

Intervening Events. The proposed regulations confirm that a plan may provide that an intervening event may override an existing payment schedule already in payment status, even if it results in a more rapid payment of the service provider's total account, so long as the intervening event is also a permissible payment event under section 409A.

- *Example:* A plan may provide that in the event a service provider dies or becomes disabled after installment payments have commenced, but before all payments have been made, all remaining amounts will be paid to the service provider in a single lump sum payment.

Plan Terminations. The regulations provide three circumstances under which a plan may be terminated at the discretion of the service recipient, so long as the plan provides for such terminations.

- A plan may be terminated if (i) all plans of the same type (e.g., all account balance plans) are terminated with respect to all participants, (ii) no payments other than those otherwise payable under the terms of the plan, without regard to the termination, are made within 12 months of termination, (iii) all amounts are paid within 24 months of termination and (iv) no new plan of the type terminated may be adopted for a period of 5 years following the termination date.
- A service recipient may elect to terminate a plan and make payments to the participants during the 30 days preceding or 12 months following a change in control of a corporation, provided that certain conditions are met.
- A plan may provide that it automatically terminates upon a corporate dissolution taxed under section 331, or with the approval of the bankruptcy court, provided that certain conditions are met.

Stock Compensation Provisions in Proposed Section 409A Regulations

Cindy V. Schlaefel

This article discusses the key provisions of the proposed regulations under section 409A applicable to stock compensation and related issues raised by the proposed regulations.

Application of Section 409A to Equity Compensation

As it did in Notice 2005-1, which was issued on December 20, 2004, the IRS confirmed in the proposed regulations that stock options and stock appreciation rights (SARs) may be subject to section 409A as "deferred compensation" if granted at less than fair market value, or if modified or extended after grant or providing other deferral features. Section 409A provides that deferred compensation cannot be paid to the service provider except upon the occurrence of one of six specific events (*i.e.*, fixed date(s), separation from service, death, disability, change of control or hardship), with no general right to accelerate the payment. Stock options and SARs that give the holder the right to decide when to exercise the vested portion of the award would

therefore violate the requirements of section 409A, if applicable.

Section 409A applies to stock rights granted after 2004, and stock rights granted before 2005 if not fully earned and vested before this year or if materially modified after October 3, 2004. The consequences of violating section 409A include an immediate income tax imposed on the holder of the stock award upon vesting, an additional income tax of 20 percent and possible interest charges. The employer may also be liable for any failure to comply with applicable withholding and reporting obligations.

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Notice 2005-1 provided exceptions from the application of section 409A for stock rights meeting certain conditions, and the proposed regulations expand upon that guidance. The proposed regulations would not become effective before January 1, 2007, but taxpayers may rely upon them, along with the provisions of Notice 2005-1 and a good faith interpretation of the statute, to the extent that an issue is not addressed in the Notice or other published guidance with an effective date prior to 2007.

Certain transition relief provided in Notice 2005-1 for correcting violations of section 409A will not be available after the end of this year. Prompt action may therefore be required, as described below.

General Exception for Stock Options and SARs

A stock option or SAR with an exercise price that can never be less than the fair market value of the stock on the date of grant, and that has no other feature for the deferral of compensation, is generally not subject to section 409A.

- In addition, section 409A generally does not apply to incentive stock options qualifying under section 422, employee stock purchase plans qualifying under section 423, and transfers of restricted stock under section 83.

New Conditions for General Exception for Stock Options and SARs

While the proposed regulations eased several of the conditions for the general exception for stock options and SARs from section 409A, they would also impose new conditions for the general exception.

Only Common Stock. The proposed regulations would require that the stock subject to the stock option or SAR be common stock having the greatest aggregate value of any class of common stock outstanding and not contain any dividend or liquidation preferences. Thus, compensatory options and SARs on the preferred stock of a corporation will not qualify for the general exception. Dividend equivalent rights may be provided, but may not be contingent on the exercise of the stock right.

Must be a Related Issuer. The stock options and SARs must be issued to service providers of the corporation that issues the stock, or an affiliate in which the issuing corporation has at least a 50 percent interest (or at least a 20 percent interest, such as a joint venture employing

former employees of the issuer, when due to legitimate business criteria). Any election to use the 20 percent rather than 50 percent as a threshold interest must be applied consistently to all compensatory stock plans of the company for a minimum of 12 months.

Valuation Methodologies. The proposed regulations place a great deal of importance on the methodology for the valuation of the underlying stock of the stock option or SAR in order for the general exception to apply.

Public Company Stock. The proposed regulations state that the value of public company stock may be determined based on market reported prices. The proposed regulations also provide that valuations based on an average of market prices (as may be required by foreign laws for stock awards) would be permitted under the general exception provided that the average is based on the market prices during a specified time period within 30 days before and 30 days after the date of grant and the terms of the grant are irrevocably fixed before the beginning of the measurement period.

Private Company Stock. The proposed regulations provide that any reasonable method may be used for private company stock, and include a list of factors that will be taken into account in determining whether a valuation method is reasonable.¹ The proposed regulations also provide that the following valuation methods will be presumed reasonable if consistently applied:

- Valuations based on an independent appraisal meeting certain requirements will be presumed reasonable for a period of one year.
- Valuations based on a non-lapse formula which applies to all transactions in the company's stock, both compensatory and non-compensatory, may qualify as reasonable.

¹ These factors include the value of tangible and intangible assets, the present value of future cash-flows, the market value of stock of similar entities engaged in substantially similar businesses, and other relevant factors including control premiums or discounts for lack of marketability, provided that all available information material to the value of the company is taken into account. The IRS would also look at whether the valuation method is used for other purposes that have a material economic effect on the company, its stockholders or its creditors. The valuation must be as of a date within the last twelve months, and be updated for any subsequent developments that may materially affect the value of the company.

- For start-up companies (less than 10 years in business) with illiquid stock, a valuation may be presumed reasonable if made by someone with significant knowledge and experience or training in performing similar valuations, and evidenced by a written report taking into account the factors described above. However, this presumption is not available if a public offering or change in control is reasonably anticipated within the next 12 months.

At a minimum, these valuation standards suggest the need for more specific information regarding stock valuation than may typically have been included in the minutes of private company board of directors meetings at which grants of stock rights are approved. The proposed regulations may also be read to encourage the use of third party appraisals. However, pending the finalization of the proposed regulations, taxpayers may rely on a good faith interpretation of Notice 2005-1, which simply requires that any reasonable valuation method be used.

For companies undergoing IPOs, the consequences of taking “cheap stock” charges for financial reporting purposes for pre-IPO stock options have added significance under section 409A.

Modifications. Certain modifications that enhance the rights or benefits of an outstanding stock option or SAR may result in a deemed grant of a new stock option or SAR on the modification date. If the modified stock option or SAR is in-the-money, or if the stock option or SAR is renewed or extended, section 409A may become applicable.

The proposed regulations provide that the following modifications will not be considered a new grant:

- Modifications adverse to the stock option or SAR holder.
- Acceleration of vesting or exercisability if the stock option or SAR was not immediately exercisable.
- Extensions of the post-termination exercise period to a date not later than the 15th day of the third month following the date the right otherwise would have expired or, if later, December 31 of the calendar year in which the right would have expired.
- Extensions of the post-termination exercise period where applicable securities laws would prohibit exercise, but only until 30 days after the date the prohibition lapses.
- Assumptions or substitutions of stock rights in mergers or other corporate transactions where, among other conditions, there is no increase in the aggregate spread between stock value and exercise price.
- Amendments to permit transfers.
- Amendments to permit an exchange of the stock right for a cash amount equal to the amount that would be available if the stock right were exercised.
- Amendments to permit payment with pre-owned stock or to facilitate payment of taxes on exercise.
- Modifications based on stock dividends, stock splits or similar changes in capitalization as permitted by incentive stock option tax regulations.

Restricted Stock Units (RSUs) to Benefit From Special Deferral Election Rule

RSUs are contractual promises by a corporation to grant stock in the future if pre-determined vesting requirements are satisfied. RSUs may be treated as deferred compensation subject to section 409A if the shares are not delivered at the time of vesting. Unless the award was performance-based, an election by the service provider to defer the delivery of shares to a later year would generally not be timely unless the deferral election was made in the year prior to the year in which the RSUs are awarded. To address this impractical result, the proposed regulations provide a special rule for initial elections to defer payment of awards such as RSUs. If the award is contingent on the performance of services for a period of at least 12 months, an election to defer will be timely if made no later than 30 days after the date of grant, and at least 12 months before the end of the service vesting period.

Action Required in 2005

Under Notice 2005-1, taxpayers may be permitted to cancel deferral elections before the end of 2005. The proposed regulations do not extend this relief. Stock options that would be subject to section 409A because they were granted at a discount may be exercised this year, and treated as a cancellation of the deferred compensation without violating section 409A. But exercises of those options after this year may violate section 409A. Similarly, if the option is adjusted to increase the exercise price to the fair market value at the grant date and thereby exempt the option from section 409A, the company may compensate the holder for the adjustment but only before the end of this year.

Proposed Regulations Clarify Application of Section 409A to Foreign Benefit Arrangements

Mark C. Jones

This article discusses the key provisions of the proposed section 409A regulations applicable to foreign benefit arrangement and related issues raised by the proposed regulations. The proposed regulations clarify, among other things, that certain non-U.S. plans and arrangements and certain arrangements with non-U.S. residents are excluded from section 409A's scope. The proposed regulations also set forth conditions for the exclusion of stock options and stock appreciation rights on foreign stock.

Section 409A's Restrictions on Nonqualified Deferred Compensation Plans

In general, section 409A permits the deferral of taxation on benefits provided under a nonqualified deferred compensation plan only if the plan imposes certain restrictions on the distribution of benefits and the employee makes a timely election as to the form and time of payment. Section 409A defines "nonqualified deferred compensation plan" as "any plan that provides for the deferral of compensation," subject to certain narrow exceptions. Shortly after the IRS issued its initial guidance on the restrictions, benefits practitioners requested clarification on the circumstances in which plans maintained by non-U.S. employers would be considered "nonqualified deferred compensation plans" for this purpose. One concern was that foreign employers with benefit plans covering only a few U.S. taxpayers would be unduly burdened by the requirement to amend their plans for the new rules.

Foreign Exemptions

The regulations address this concern and related concerns by carving out certain exemptions from the definitions of "nonqualified deferred compensation plan" and "deferral of compensation." In particular, the regulations exclude the following:

- **Plans and arrangements covered by tax treaties**, if the contributions to the plan are exempt from U.S. income tax pursuant to the treaty or the compensation deferred would have been exempt at the time the employee first had a nonforfeitable right to the compensation.

- **Foreign social security systems**, if the contributions or benefits are exempt from U.S. income tax pursuant to a totalization agreement or the contributions are mandated by the foreign jurisdiction.
- **Non-U.S. source income**, if the employee was a nonresident alien and the compensation deferred would have been exempt at the time he or she first had a nonforfeitable right to the compensation.
- **Foreign earned income**, if the compensation deferred would have been exempt at the time the employee first had a nonforfeitable right to the compensation, and, when combined with the foreign earned income claimed for the year of vesting, would not have exceeded the maximum exclusion permitted under section 911 (currently, \$80,000).
- **Foreign funded plans**, if contributions to the trust are taxable under section 402(b) of the Code.
- **Broad-based foreign retirement plans maintained by a non-U.S. employer**, to the extent they cover non-U.S. citizens who are not lawful residents. Otherwise, this exclusion applies only to nonelective deferrals of foreign earned income and only to the extent the deferrals would not exceed dollar limits applicable to U.S. qualified retirement plans under section 415. For this purpose, "broad-based retirement plan" means any written plan that (i) provides significant benefits to a wide range of employees, including rank and file employees, substantially all of whom are nonresident aliens, (ii) limits the ability of employees to withdraw their benefits prior to retirement or separation from service and (iii) provides for payment of a "reasonable level

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of benefits” at death, a stated age or a change in work status and requires minimum distributions to ensure that any death benefits provided to the employee’s beneficiaries are incidental to the retirement benefits provided to the employee.

- **Compensation of employees of foreign governments and international organizations**, if the compensation deferred would have been exempt at the time the employee first had a nonforfeitable right to the compensation.
- **Compensation from certain U.S. territories**, including Puerto Rico, Guam, American Samoa and the Northern Mariana Islands, if the compensation deferred would have been exempt at the time the employee first had a nonforfeitable right to the compensation.
- **Tax equalization arrangements**, if the payment is made by the end of the second calendar year after the calendar year in which the employee’s U.S. federal income taxes are due and the payment does not exceed the difference between the foreign taxes actually imposed on the employee’s compensation and the amount that would have been due under the U.S. federal income tax.
- **De minimis amounts** contributed by a nonresident alien to a plan maintained by a non-U.S. employer, to the extent the amounts deferred do not exceed \$10,000 per year.

Foreign Funded Plans

Participation in a foreign funded plan is not subject to section 409A. As a nonqualified plan funded with a nonexempt trust, taxation of participants is governed by section 402(b) of the Code.

Incoming Resident Aliens

Benefits practitioners also asked the IRS to clarify how section 409A would apply to employees who were not U.S. residents when they initially earned or vested in the compensation deferred but became U.S. residents before the benefits were distributed. The concern was that the deferred amounts would become immediately taxable under section 409A when the employee became a resident of the United States because the plan or the employees’ election was not required to meet the statutory requirements at the time of deferral.

The proposed regulations provide relief for this situation by allowing employers to amend their plans for section 409A as late as December 31 of the year in which the employee is first classified as a resident alien. The employee also has until December 31 of the year in which he or she becomes a U.S. resident to make a deferral election as to compensation on services performed for that year and as to deferred amounts that are still subject to a substantial risk of forfeiture as of January 1 of that year.

Options and SARs on Foreign Securities

In its initial guidance under section 409A, the IRS stated that nonqualified stock options and stock appreciation rights (SARs) would not be considered “deferred compensation” if the exercise price could never be less than the fair market value of the underlying stock at the date of grant and certain other requirements were met. If the stock is readily tradable on an established securities market, then “fair market value” for this purpose is to be determined by the stock’s trading price. Benefits practitioners asked for clarification as to how this exemption might apply to options and SARs on American Depository Receipts (ADRs) and securities traded on a foreign exchange.

The proposed regulations clarify that the exemption for nonqualified stock rights applies to options and SARs on ADRs if the other criteria of the exemption are met. They also clarify that a foreign national securities exchange is considered to be an “established securities market” for purposes of determining the fair market value of the underlying stock as long as the exchange is officially recognized, sanctioned or supervised by governmental authority.

To qualify for exemption under the initial guidance, the exercise price of options and SARs on stock readily tradable on an established market had to be based on the closing price of the underlying stock on the trading day before or the trading day of the date on which the stock right was granted, last sale before or the first sale after the date of grant, or any other reasonable basis using reported transactions. It was noted that these methods would conflict with laws in certain foreign jurisdictions that require the exercise price of compensatory options to be based on an average of the underlying stock over a period of time in order to receive favorable tax treatment. To

allow compliance with these requirements, the proposed regulations provide that employers may comply with the exemption for options and SARs if the exercise price is based on an average of the price of the underlying stock over a specified period, as long as the period falls within 30 days before and 30 days after the date of grant, the terms of the grant are fixed before the beginning of the measurement period, and the same valuation method is used consistently for all grants of stock rights.

Offshore Trusts

In addition to imposing income and penalty taxes on certain deferred compensation benefits, section 409A imposes income and penalty taxes on any assets set aside in an offshore trust to pay for deferred compensation benefits. The proposed regulations do not cover these provisions. The IRS has promised to address them in later guidance.

Material Available On-Line

The following material is available with the indicated file sizes.

- **Proposed section 409A regulations**, as published in the October 4, 2005 Federal Register. [272K]
- **Notice 2005-1**. [201K]
- **Text of section 409A**, as enacted as part of the American Jobs Creation Act of 2004 (Conference Committee Report, H.Rpt. 108-755, pp. 221-227). [65K]
- **Conference Committee explanation for section 409A** (Conference Committee Report, H.Rpt. 108-755, pp. 706-724). [80K]

Important Notice to Readers

This material is not intended to constitute a complete analysis of all tax considerations. Internal Revenue Service regulations generally provide that, for the purpose of avoiding United States federal tax penalties, a taxpayer may rely only on formal written opinions meeting specific regulatory requirements. This material does not meet those requirements. Accordingly, this material was not intended or written to be used, and a taxpayer cannot use it, for the purpose of avoiding United States federal or other tax penalties or of promoting, marketing or recommending to another party any tax-related matters.