

Treasury and IRS Issue “Second Round” of 409A Guidance: What Companies Need to Know and Do Before Year End

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The Treasury Department and Internal Revenue Service have issued the long-awaited “second round” of guidance on the new deferred compensation law under Internal Revenue Code Section 409A (409A). The new guidance was issued in the form of comprehensive proposed regulations (238 pages in length). The proposed regulations provide welcome extended transitional relief on some (but not all) 409A action items, some important new 409A exemptions, and clearer guidance on how to comply with 409A. This article summarizes the key points of the new guidance and includes an action checklist on what companies should (and should not) do before the end of 2005.

BACKGROUND

In October 2004, Congress enacted the American Jobs Creation Act of 2004. The Jobs Act made sweeping changes to the law governing nonqualified deferred compensation plans. The law was codified in a new Section 409A of the Internal Revenue Code. 409A imposes strict rules on nonqualified deferred compensation and severe tax treatment (20 percent penalty, income tax on vesting and interest) for plan participants if the rules are not followed. The new law is very broad in scope and covers many arrangements that are not typically considered deferred compensation, including, for example, certain equity arrangements, foreign plans, and separation pay arrangements.

409A became effective as of January 1, 2005.¹ In late December 2004, Treasury and IRS issued the “first round” of guidance on 409A in the form of Notice 2005-1. Notice 2005-1 provides certain transitional relief and limited guidance on how to comply with the law in 2005. The proposed regulations provide extended transitional relief and more comprehensive guidance on 409A.

TRANSITIONAL RELIEF

Certain Deadlines Extended Until December 31, 2006. The proposed regulations

extend until December 31, 2006, the deadline for (1) amending plans to comply with 409A (or structuring plan documents to be exempt from 409A), (2) changing *certain* payment elections, and (3) continuing to link time and form of payment elections under supplemental pension and savings plans to payment elections under tax-qualified plans.

Other Deadlines Remain December 31, 2005. The proposed regulations *do not* extend the deadline for (1) terminating arrangements (including any grandfathered arrangements in effect before October 4, 2004, that do not contain a provision for mandatory distributions upon plan termination), (2) canceling deferral elections (including, for example, cash-outs of discounted stock rights), (3) changing the time and form of payment of amounts that would otherwise be payable in 2006 or to cause payments to be made in 2006, or (4) amending plans to allow deferral elections for 2005 to be made through March 15, 2005 (but only if the arrangement did in fact take advantage of this transition rule in 2005). The deadline for these actions remains December 31, 2005. After 2005, there will be strict limits on a company’s ability to terminate arrangements subject to 409A and certain grandfathered arrangements that are not otherwise subject to 409A.

Continued Good Faith Compliance. Plans must continue to operate in good faith compliance with 409A. Until at least January 1, 2007, reliance on the Notice and/or the proposed regulations will be deemed to be good faith compliance.

EQUITY ARRANGEMENTS

Broadened Exemption for SARs. The Jobs Act specifically exempted “non-discount” stock options. Notice 2005-1 extended the exemption for non-discount stock options to non-discount stock appreciation rights (SARs) of public companies that are settled in stock and *temporarily* exempted SARs of public and private companies (whether settled in stock or cash) under programs in effect before October

4, 2004. The proposed regulations broaden the exemption for SARs to cash or stock-settled SARs of either public or private companies.

To be exempt from 409A, the exercise price of the stock option or SAR may never be less than the fair market value of the underlying stock on the date of grant and the option or SAR must not have any discount element or deferral feature other than the right to exercise the option or SAR.

Broadened Definition of "Service Recipient Stock." The exemption for stock options and SARs applies only to options or SARs in "service recipient stock." The good news is that the proposed regulations expand the term "service recipient" to include certain 50 percent or more owned entities (20 percent in certain cases) and expand the exemption to options and SARs in stock traded on foreign exchanges and over-the-counter, and to American Depositary Receipts (ADRs) and multi company units. The bad news is that the exemption applies only to options and SARs in *common stock* of the service recipient and does not apply to preferred stock or classes of stock that have puts or calls measured at less than fair market value.

Stock Valuation Methods. For purposes of 409A, the proposed regulations provide public companies with more flexibility in determining the value of stock (including, for example, using the average selling price during a 30-day period before or after the grant) and provide private companies with limited safe harbors for valuing stock. These safe harbors include

the use of (1) certain independent appraisals that may be relied on for up to 12 months (absent an event that materially changes the value of the company), (2) the use of non-lapse restriction formulas (for example, book value) that are used consistently for *all compensatory and non-compensatory* purposes of the company, and (3) more lenient valuation rules for illiquid stock of start-up companies.

Modifications, Extensions, Renewals. The modification, extension, or renewal of an otherwise exempt stock option or SAR could cause the option or SAR to become subject to 409A. The proposed regulations provide that, for purposes of 409A, (1) the addition of certain cashless exercise features or the shortening of the exercise period will not be considered a modification, (2) the extension of the exercise period to the later of the end of the calendar year or 2½ months after the exercise period would otherwise expire (or the minimal extension of the exercise period to avoid violations of securities laws) will not be considered an extension, and (3) acceleration of vesting will not cause an otherwise exempt stock right to become subject to 409A.

Stock Right Adjustments in Corporate Transactions. The proposed regulations provide favorable rules that allow companies to adjust and substitute stock rights in connection with certain corporate transactions without adversely affecting otherwise exempt options and SARs.

Dividend Rights. The proposed regulations provide guidance on dividend rights. Basically, dividend rights must either be paid out cur-

rently or set aside separately and deferred and paid out in accordance with 409A.

OTHER ARRANGEMENTS

Short Term Deferrals. Notice 2005-1 provides a temporary exemption from 409A for amounts that are paid no later than 2½ months after (1) the participant's tax year in which the amount is vested or (2) the company's tax year in which the amount is vested, whichever is later. The short term deferral exemption may be used to exempt many arrangements that would otherwise be subject to 409A, including, for example, certain bonus arrangements and separation pay arrangements. The proposed regulations would make the short term deferral exemption permanent. The preamble to the proposed regulations clarifies that the plan document need not specify that amounts will be paid within the short term deferral period as long as the amounts are actually paid within such period. However, if the plan document does specify that amounts will be paid out within the short term deferral period or if the plan does specify a fixed payment date (or otherwise permissible payment event), then the company can take advantage of some favorable administrative relief for late payments.

Supplemental Pension and Savings Plans. The proposed regulations allow the continued linkage of benefit accruals under supplemental employee retirement plans (also called SERPs) to accruals under related tax-qualified pension plans. The proposed regulations also

allow deferrals under supplemental savings plans (often called 401(k) wrap plans) to continue to be linked to deferrals made under related tax-qualified 401(k) plans, as long as any change in deferral linked to the underlying tax-qualified plan is limited to the maximum 402(g) limit (\$14,000 for 2005 and \$15,000 for 2006) for supplemental elective deferrals and to the maximum Internal Revenue Code Section 402(g) limit for any supplemental matching contributions. Payments made under SERPS and 401(k) wrap plans may continue to be linked to elections made under the related tax-qualified plans through the end of 2006. After 2006, elections as to the time and form of payment under supplemental pension and savings plans can no longer be linked to tax-qualified plans.

Foreign Plans and Employees. The proposed regulations provide several exemptions for foreign plans, including exemptions for certain broad based foreign retirement plans, foreign plans funded through traditional trusts, foreign plans covered by tax treaties and social security systems mandated by foreign governments. There is also an exemption for tax equalization allowances up to certain limits. Special rules apply to U.S. citizens and resident aliens working abroad and non-resident aliens who become employed in the U.S.

Separation Pay Arrangements. The proposed regulations make clear that separation pay arrangements may be subject to 409A, but provide the following useful exemptions for separation pay:

- *Two Times Pay/Two Year Payout Exemption.* Separation pay in connection with an involuntary separation of employment or voluntary early retirement program (VERP) is exempt if (1) the total separation pay does not exceed two times annual pay for the year before termination of employment (up to a maximum of two times the annual pay limit under Internal Revenue Code Section 401(a)(17) (this annual pay limit is \$210,000 for 2005 and \$220,000 for 2006), and (2) all payments are made before the end of the second calendar year following the year in which termination occurs. This exemption does not apply to separation pay made in connection with “good reason” triggers.
- *Short-Term Deferrals.* Separation pay paid in connection with an *involuntary or voluntary* separation from service may qualify under the short-term deferral exemption. There is some question as to whether the short-term deferral exemption may be used in connection with “good reason” separations from service.
- *Expense Reimbursement.* Reimbursement of certain expenses such as outplacement and moving expenses and medical payments (as well as other payments that do not exceed \$5,000 in total) that are paid out completely by the end of the second calendar year following the year of separation from service are exempt.
- *Collectively Bargained Plans.* Separation pay paid pursuant to collective

bargaining agreements is exempt.

The proposed regulations also provide guidance on how to determine who is a key employee.

Arrangements for Directors and Independent Contractors. The proposed regulations continue to provide that 409A applies to directors, but clarify that a failure under a director’s nonqualified deferred compensation arrangement with one company will not taint arrangements that the director may have with other companies. The proposed regulations also provide detailed rules that exempt from 409A deferred compensation paid to independent contractors that provide significant services to two or more unrelated companies.

Hedge Funds. The proposed regulations contain a special exemption for *certain* “back-to-back” deferral arrangements commonly used by hedge funds. Treasury and IRS are expected to issue additional guidance affecting hedge fund deferral and funding arrangements.

Split-Dollar Life Insurance. The proposed regulations provide limited guidance on how 409A applies to split-dollar life insurance arrangements. The guidance exempts many forms of split-dollar life insurance arrangements (for example, death benefit only arrangements and certain arrangements structured as loans), but makes clear that other split-dollar life insurance arrangements (for example, certain equity and below-market loan arrangements) may be subject to 409A.

Section 457(f) Plans. The proposed regulations provide

only limited guidance on how 409A applies to nonqualified deferred compensation arrangements sponsored by tax-exempt employers.

409A RULES

Initial Deferral Elections. The proposed regulations provide substantial guidance on and administrative relief for initial deferrals, including rules that permit the use of the following deferral arrangements:

- *Evergreen provisions* (deferral elections that remain in effect from year to year) do not violate 409A as long as the election becomes irrevocable (except for changes that comply with 409A's subsequent election rules) with respect to future compensation by the last date by which an initial deferral election could be made for that compensation; and
- *Ad hoc awards* may be deferred after the start of the taxable year as long as the initial deferral election is made within 30 days of the date of grant and at least 12 months before the end of the service period. This rule should enable companies to award restricted stock units during the year without violating the initial deferral rules of 409A.

Subsequent Deferral Elections. The proposed regulations provide detailed rules on subsequent deferral elections, including guidance on how these rules apply to installments and annuities.

Time and Form of Payment. The proposed regulations provide useful guidance on how to structure payments to comply with 409A. The new guidance permits, for example:

- *Multiple payment events and forms*, including payment on the earlier or later of two or more permissible payment events and payment in one form for one event and in another form for another event (for example, lump sum on death and installments upon separation from service);
- *Payments for administrative convenience*, for example payment on the first date that it is administratively feasible following the fixed payment date or payment anytime within the calendar year if the calendar year is designated as the fixed payment date:
 - *Payments upon violation of 409A*;
 - *Payments upon plan termination* (see below); and
 - *Earn-outs* paid pursuant to a change of control, if the amount is paid on the same schedule and on the same terms and conditions as payments made to other shareholders, as long as the earn-out is fully paid within five years following the change of control.

The proposed regulations also contain detailed rules on what is a payment, distributions following a change of control, payments based upon certain "events" and payment delays by the company in certain cases.

Anti-Acceleration of Benefits. 409A prohibits the acceleration of benefits except in certain cases. Notice 2005-1 provides several exceptions to the anti-acceleration rules. The proposed regulations add new exceptions, including the right to terminate deferral elections following an

unforeseeable emergency and following plan terminations:

- *Cancellations of deferrals* are permitted following an unforeseeable emergency distribution under an arrangement subject to 409A or a hardship distribution under a 401(k) plan; and
- *Terminations of plans* subject to 409A and certain grandfathered plans (at the company's discretion and in accordance with plan terms) are permitted only under the following circumstances: (1) within 12 months following a change of control; (2) upon corporate dissolution or with approval of the bankruptcy court; or (3) if the company chooses to terminate all plans of the same type, all benefits are paid out between 12 and 24 months following plan termination and the company does not establish a plan of the same category for five years after plan termination. These rules are very strict and are designed to discourage companies from using plan termination as a means to accelerate payment of deferred compensation.

Material Modifications of Grandfathered Benefits. Notice 2005-1 provides that compensation deferred under programs in effect before October 4, 2004, are grandfathered to the extent that the amounts deferred were earned and vested before 2005. Grandfathered arrangements that are "materially modified" would become subject to 409A. The proposed regulations provide additional guidance on what constitutes a material modification and include a special excep-

tion for inadvertent modifications if the modification is rescinded by the earlier of (1) any date before which the additional right granted by the modification is exercised, and (2) the last day of the calendar year in which the modification was made.

Plan Aggregation. Notice 2005-1 provides that, for purposes of certain 409A rules (for example, imposition of penalties and termination of plans), arrangements will be aggregated with similar arrangements under one of three categories (equity, account balance, and other). The proposed regulations carve out a new fourth category for separation pay arrangements.

ADDITIONAL 409A GUIDANCE EXPECTED

The proposed regulations do not address reporting and disclosure, offshore trusts, partnership arrangements, or 409A penalties and taxes. Additional guidance on reporting and disclosure is expected soon followed by guidance on penalties and certain other open issues.

PUBLIC COMMENTS REQUESTED

Treasury and IRS have requested public comments on the proposed regulations and on a number of specific issues including, for example, how 409A applies to partnership arrangements, severance arrangements with good reason triggers, split-dollar life insurance arrangements, and 457(f) plans. The deadline for submitting written comments is January 3, 2006. A public hearing on the proposed regulations is scheduled for January 25, 2006.

ACTION PLAN: WHAT TO DO (AND NOT DO) BEFORE THE END OF 2005

1. *Become Familiar with Proposed Regulations and How They Affect Your Company's Nonqualified Deferred Compensation Plans.*

2. *Determine Whether to Terminate Any Arrangements Before 2006.* Determine whether the company wishes to terminate any nonqualified deferred compensation plans before the end of 2005 to avoid compliance with 409A. After 2005, 409A imposes strict limitations on terminating plans. If your company does decide to take advantage of the 2005 plan termination relief, all amounts must be paid out under the plan in 2005.

3. *Determine Whether to Allow Participants to Cancel Elections Before 2006.* Determine whether employees will be given the option of canceling deferred compensation subject to 409A before the end of 2005. The deadline for canceling such deferrals remains December 31, 2005.

• *Consider:* Companies may wish to consider giving participants the choice of canceling any deferred compensation subject to 409A before the end of 2005. Any canceled deferrals must be taken into income in 2005. *A word of caution:* If a participant is given the choice to cancel an otherwise grandfathered amount, the grandfathered amount will become subject to 409A.

4. *Determine Whether to Allow Participants to Change Certain Payment Elections*

Before 2006. Determine whether employees will be given the option of changing payments otherwise due in 2006 or accelerating payment into 2006 of any amounts otherwise payable after 2006. The deadline for changing the time and form of such payments remains December 31, 2005.

5. *Take All Action Required Before 2006.* If your company does decide to terminate a plan or allow participants to cancel deferrals or change 2006 payments, all action (including, for example, board and committee resolutions, participant consents, and notification to third-party providers) must be taken before the end of 2005. Also, if your company took advantage of the special transitional rule in Notice 2005-1 that allowed participants until March 15, 2005, to make or change deferral elections for 2005, all action to document and approve such deferrals must be taken before the end of 2005.

• *Consider:* Given the very short timeframe between now and year end, consider delegating board or committee responsibility for such terminations, cancellations, and notices.

6. *Determine Deadlines for Deferring 2006 Compensation.* Review plans to determine deadlines for completing elections to defer 2006 compensation. Elections to defer compensation earned in 2006 generally must be made no later than December 31, 2005. Extended deadlines apply to qualifying performance-based compensation and to new hires.

• *Consider:* Particular care should be taken to review

bonus and other incentive plans to determine whether the arrangement qualifies for the extended deadline for deferring performance-based compensation.

7. Complete Election Forms for 2006 Deferrals. Obtain completed election forms to defer compensation earned in 2006 by December 31, 2005 (other than qualifying performance-based compensation).

8. Consider Submitting Comments to Treasury and IRS. Consider submitting comments to Treasury and IRS on how the proposed regulations should be changed to address particular issues for your company's plans. Consider working with industry organizations or counsel to submit the comments. The deadline for submitting comments to the Treasury and IRS is January 3, 2005.

9. Continue to Operate in Good Faith Compliance. Continue to operate nonqualified deferred compensation plans in good faith compliance with 409A, including the new proposed regulations and Notice 2005-1.

10. Wait Until at Least 2006 to Formally Amend Plans. Except for amendments to

terminate plans, to permit cancellation of deferrals or changes in certain payment elections required before the end of 2005, or to conform with any deferral elections permitted in 2005 with respect to 2005 compensation, companies are generally advised to wait to formally amend their nonqualified deferred compensation arrangements until the proposed regulations are finalized next year. ❁

NOTE

1. 409A applies to (1) amounts earned and vested after December 31, 2004, and (2) amounts earned and vested before January 1, 2005, if the plan is "materially modified" after October 3, 2004. Amounts earned and vested as of December 31, 2004, are "grandfathered" and not subject to 409A, as long as (1) the plan is not "materially modified" after October 3, 2004, and (2) the participant has a legally binding right to the amount as of December 31, 2004.

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