TAX UPDATE

ROPES & GRAY

NEW 409A RULES

October 28, 2005

New deferred compensation rules enacted last year (Section 409A of the Code, or § 409A) dramatically change the way employers[1] can deliver compensation and benefits on a tax-effective basis. In December, IRS Notice 2005-1 gave taxpayers useful ground rules and transition-period relief but also promised more detail in the form of regulations. The IRS has now issued lengthy *proposed* § 409A regulations (the "Regulations").

The Regulations are not scheduled to take effect until 2007. They extend some transition periods to the end of 2006 (*see below,* "Effective Dates and Transition Rules"). However, they continue to impose a **December 31, 2005** deadline on those wishing to cancel existing deferral arrangements. Employers and employees alike will therefore want to analyze existing plans closely to determine whether action should be taken before year end.

§ 409A and the Regulations go far beyond ordinary deferral arrangements, imposing new restrictions on stock options, stock appreciation rights and other stock-based compensation, restricting severance, and eliminating important elements of flexibility in the payment of supplemental pensions. Unless specifically exempted, any arrangement under which an employee earns a right (even a conditional right) to compensation in one year and receives the compensation in a later year may be affected. A failure to comply with the new rules can be costly: the penalty for noncompliance is acceleration of taxable income plus an additional 20% tax plus, in some cases, an interest charge.

The discussion that follows summarizes selected key topics covered by the Regulations. The Regulations provide significant additional details and guidance. On some important questions the IRS has not yet spoken, including § 409A's funding rules and the rules for determining the amount and timing of income inclusion under an arrangement that does not comply with § 409A.

Questions on § 409A or this summary should be directed to Ron Groves, Jon Zorn, Loretta Richard, Charlotte Hemr, Bill Jewett or Anne Bourdine or to any lawyer within the Ropes & Gray Tax & Benefits Department.

[1] § 409A applies broadly to arrangements between "service providers" and "service recipients." For ease of presentation the following overview uses the term "employer" and "employee", but the rules that are described generally extend to other service relationships (for example, involving independent contractors).

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STOCK-BASED AWARDS

Notice 2005-1 exempted certain stock options and stock appreciation rights (SARs) from the reach of § 409A. The exemption was critically important because the exercise feature of the typical stock option or SAR makes it incompatible with § 409A's requirements. Notice 2005-1 also exempted most restricted stock arrangements but left many stock unit (phantom stock) arrangements subject to the new rules. The Regulations make important changes in this area.

- *Restrictive definition of "stock".* The Regulations exempt only stock options and SARs on *common* stock that has *no preference features.* (Non-lapse rights to put or call the underlying stock at other than fair market value are also prohibited.) Awards must be based on publicly traded stock where it exists. In the case of a non-public company, the Regulations require that the award be based on the class of common stock that has the highest aggregate value. These restrictions were evidently aimed at awards based on classes of stock designed specifically for compensation purposes, but they sweep in much more.

> *Why it matters:* Many companies, for non-compensatory business reasons, have equity structures that involve several classes of common and/or preferred stock. The position taken in the Regulations, if retained, will significantly hamper the ability of those companies to use stock options and SARs, and in some cases could make it impossible for them to do so.

> *Observation:* The preamble to the Regulations describes this rule as a "clarification" of earlier guidance. This seemingly unjustifiable characterization may give pause to some who would otherwise consider it reasonable to continue granting stock options and SARs on other classes of stock pending final adoption of regulations; see below, "Effective Date and Transition Rules."

- *SAR exemption expanded.* With a limited exception, Notice 2005-1 exempted SARs only if they provided for settlement in stock and then only for public companies. The Regulations extend the exemption to both stock-settled and cash-settled SARs for both public and non-public companies.

Why it matters: Accounting-rule changes are likely to make SARs more attractive to many companies.

• *Mergers, etc.* The Regulations affirm the position taken in Notice 2005-1 that in substituting or assuming non-ISOs in a merger or other corporate transaction, the parties may lower the ratio of exercise price to the fair market value of the stock so long as the aggregate option/SAR spread is not increased.

Why it matters: This allows an acquiror to "de-leverage" the equity position given to employees of the acquired company by lowering the ratio of exercise price to stock value. The acquirer can thus issue "rollover" options on fewer shares. Note, however, that other rules – not part of the Regulations – still limit how low the price of an assumed or substituted option may be set.

Observation: The longstanding assumption/substitution rule for ISOs, on the other hand, still prohibits a lowering of the ratio of exercise price to value. Where ISOs are rolled over in an acquisition, the safest course will be to leave the exercise price/value ratio unchanged.

• *Valuation of non-public company stock.* Both Notice 2005-1 and the Regulations exempt stock options and SARs only if the strike price (or the value above which appreciation is measured in the case of an SAR) may never be less than the fair market value of the underlying stock on the date of grant, the number of shares subject to the right is fixed on the date of grant, and the right has no additional deferral features. For public companies, compliance with the fair market value rule will not be difficult. For a non-public company, the Regulations require only a "reasonable application of a reasonable valuation method" taking into account all relevant factors, but then provide several safe harbors:

- Use of an independent appraisal.
- In limited circumstances, use of a consistently applied formula (e.g., book value).
- A company in business for fewer than ten years may be able to rely on a written valuation by an experienced insider (no independent appraisal is required) – but this safe harbor becomes unavailable as the company nears an IPO or sale.

> *Why it matters:* Small, non-public companies have sometimes assumed that common stock may be valued as a simple function of the price of preferred stock issued to investors, and they have declined to re-value the common stock between investor rounds. The § 409A rules will require changes in the way these companies approach valuations.

> *Observation:* Although the safe harbor for start-ups may prove helpful, some companies will conclude that an independent appraisal is the safer course.

• *Option/SAR modifications.* Because both Notice 2005-1 and the Regulations effectively prohibit in-the-money option/SAR grants or grants of options or SARs with an additional deferral feature, some rules are needed to define when a change to an option's terms results in a new grant. Unfortunately, the Regulations are not clear in all respects:

- Any "extension" or "renewal" of an option's or SAR's life eliminates the § 409A exemption for the award, regardless of whether the option/SAR is "in the money" at the time. The Regulations contain a narrow exception for certain short-term extensions and for extensions required to comply with securities laws.
- Any other modification that has the effect of lowering the strike price is treated as a new grant and therefore would eliminate any § 409A exemption if the option or SAR was "in the money" at the time of the modification.
- The Regulations state that it is not a "modification" to add a feature providing for the tendering of previously acquired stock to pay the option strike price or for share withholding to pay taxes, nor is it a "modification" for the grantor to exercise specifically reserved discretion to permit a transfer of the award.

- An acceleration of exercisability is not a "material" modification. The Regulations state that the removal of an acceleration provision is not a modification if the removal occurs before the year in which the acceleration provision would otherwise be triggered.
- A change in the terms of the underlying stock may result in a modification of an option or SAR.
- On the other hand, a change to the terms of an option or SAR that would inadvertently result in a modification and that is rescinded within the same calendar year is ignored unless the option or SAR was exercised prior to the rescission.

Why it matters: The modification rules will be critical in administering stock options and SARs. The wrong type of change may disqualify an option or SAR altogether, while others may require that the exercise price be re-tested against current fair market value.

Observation: The Regulations effectively permit options to be "repriced" to current fair market value where the value of the stock has declined. This is helpful, but in public companies, at least, repricings are rare.

- *Awards to employees, etc. of affiliates.* The Regulations liberalize the affiliation rules used in determining whether the proper service relationship exists between an individual receiving a stock option or SAR and the issuer of the stock. In most settings, Notice 2005-1 required 80% ownership (so that, for example, an issuer could not have granted a stock option qualifying for the Notice 2005-1 exemption to an employee of a 70% subsidiary). The Regulations generally permit 50% to be substituted for 80% (lower in some cases).

Why it matters: The 80% affiliation test was a trap for the unwary, not least because the more familiar ISO rule uses a 50% test. The lowered threshold should result in fewer nonqualifying awards.

Observation: Affiliation is tested at grant. Thus, a later break in affiliation (for example, if the employer subsidiary is sold) will not disqualify the award. The affiliation test may also be met in structures that include non-corporate entities (for example, partnerships), which is more generous than the ISO rule.

- *Dividend equivalents:* Dividend equivalents on stock satisfying the restrictive definition of stock described above may be paid out in the calendar year when credited or within 2½ months after year end. However, the Regulations make it clear that dividends accumulated and paid at the time of an option exercise would be treated as a reduction in the option price.
- *Restricted stock:* The Regulations affirm the position taken in earlier guidance that restricted stock awards are generally not governed by or subject to § 409A.

SHORT-TERM DEFERRALS

Notice 2005-1 contained an important exemption for "short-term deferrals" – arrangements under which payment is required to be made, and is in fact made, not later than 2½ months following the close of the year in which the right to the payment vests (i.e., ceases to be subject to any "substantial risk of forfeiture"). The Notice made the exemption applicable well beyond the classic bonus arrangement where the bonus is earned at year end and paid out several weeks later.

> *Why it matters:* In view of the widespread use of service and performance conditions and the desirability of avoiding application of the § 409A rules where possible, many employers will strive to bring arrangements within the "short-term deferral" exemption.

The Regulations retain the "short-term deferral rule" and provide additional guidance that will make it more useful in application:

- *No requirement that the payment date be formally specified.* The Regulations eliminate the requirement of earlier guidance that a "short-term deferral" arrangement must formally provide for a payout date within the short-term deferral period. Under the Regulations, operational compliance will suffice. However, this apparent liberalization is potentially a trap, because a failure to specify a payment date may result in disqualification if there is a payment delay (see below, "Payouts: Form and Timing").

- *Delays in payment permitted in some cases.* The Regulations permit a delay if the taxpayer establishes that it was administratively impracticable to make the payment by the 2½ month deadline or that making the payment would have jeopardized the solvency of the employer, if the impracticability or insolvency was unforeseeable and the payment is made as soon as reasonably practicable.

- *What is a "substantial risk of forfeiture"?* Earlier guidance provided a definition of "substantial risk of forfeiture" that was similar to, but not the same as, the rule generally thought applicable to restricted stock. The Regulations retain this approach, as follows:

  - A substantial risk of forfeiture exists where the right to payment is conditioned on the performance of substantial future services or the occurrence of a condition related to the employee's performance or to the employer's business activities or organizational goals (including, for example, the attainment of a prescribed level of earnings or an initial public offering).

Observation: The preamble to the Regulations indicates that severance arrangements may be structured to come within the "short-term deferral" rule on the ground that the right to a payment payable only upon an involuntary termination is unvested; see below, "Separation Pay."

- A commitment not to work (typically, not to compete) does not give rise to a substantial risk of forfeiture for this purpose.
- Taxpayers cannot stretch out a "short-term deferral" by extending the underlying risk of forfeiture or adding a new one.
- Under a similar rule, "short-term deferral" relief is inapplicable to deferrals of amounts that the recipient could have elected to receive – for example, salary – unless the deferred amount subject to the substantial risk of forfeiture is materially greater than the amount the recipient could have chosen to receive.

Observation: The Regulations make it clear that a payment made with restricted property – for example, a bonus paid with restricted stock – may qualify for the "short-term deferral" exemption.

• *Deferral of compensation paid under a "short-term deferral".* It was unclear under earlier guidance how someone wishing to defer a "short-term deferral" – for example, a bonus – could do so. For example, suppose an employer grants an employee, mid-year, a restricted stock unit under which 100 shares of stock will be delivered in three years' time if the employee is still employed. In year two, the employee decides that she would prefer to receive the shares in year ten. The Regulations provide that the employee can still, in that case, make the deferral election but only if the election satisfies the "re-deferral" rules (see below under "Subsequent Elections"). The election could provide, however, that the deferred amounts will be payable upon a change in control event (without regard to the 5-year additional deferral requirement), in addition to any earlier payments permitted generally under the re-deferral rules.

INITIAL DEFERRAL ELECTIONS

§ 409A generally provides that an election to defer compensation for services performed during a taxable year must be made by the end of the preceding taxable year.

- *Fiscal Year Employers.* In general, the relevant year for making elections is the calendar year (the employee's taxable year). However, initial elections pertaining to certain fiscal-year-based compensation may be made later, before the beginning of the fiscal year. (The fiscal-year exception is limited, however. For example, it does not cover salary or other amounts paid during the fiscal year.)

- *"Evergreen" Elections.* Evergreen deferral elections (i.e., elections that remain in place until changed by the employee) are effective provided they become irrevocable each December 31 (or applicable fiscal-year date) for compensation payable for services in the immediately following year.

- *Non-elective Arrangements.* Non-elective arrangements – for example, a typical SERP – must designate the time and form of payment up front. The Regulations treat the designation as an initial deferral election for purposes of § 409A.

> *Observation:* By treating non-elective arrangements in this way, the Regulations allow a participating employee to "re-defer" payments under the subsequent election rules; see below, "Subsequent Elections."

- *Mid-Year Awards.* The Regulations permit mid-year elections in limited cases. An employee who first becomes eligible for a plan mid-year may make an election (as to compensation for services later in the year) within 30 days of eligibility. A similar mid-year election is available for awards where the employee must work for at least 12 months to earn the award and the election is made at least 12 months in advance of the end of the service period.

> *Observation:* The "first year of eligibility" rule may be less valuable than it appears at first glance, because plans of the same type are aggregated (see below, "Aggregation Rules"), and an employee who becomes eligible for one plan cannot thereafter claim initial eligibility with respect to other plans of the same type.

- *Linked Plans.* The Regulations provide some help to those who maintain nonqualified plans linked with qualified plans – for example, SERPs with an offset formula – notwithstanding the arguably "elective" effect that some changes in the qualified plan may have on the nonqualified benefit. A very common form of linkage, however – tying payments under a SERP to the form of payment

under the corresponding qualified plan – has been given only temporary transition relief; see below, "Effective Dates and Transition Rules."

- *Performance-based Compensation.* In general, § 409A provides that an election with respect to performance-based compensation with a performance period of at least 12 months may be made up to six months before the end of the performance period.

> *Observation:* The Regulations eliminate a significant limitation in Notice 2005-1 by permitting performance-based compensation to be based solely on an increase in the value of the employer, or the stock of the employer, after the date of grant or award.

PAYOUTS: FORM AND TIMING

In General

§ 409A requires that payments be made either at a fixed date or under a fixed schedule, or upon any of the following: death, disability, a corporate change in control, an unforeseeable emergency, or a separation from service (six months after separation, for key employees of a public company).

> *Observation:* The Regulations provide definitions for the relevant terms. The "change in control" definition merits particular attention – not all control-shifting events are covered. Note, however, that the "short-term deferral" rules may permit unvested amounts to be paid out on a liquidity event that would not constitute a change in control on which amounts treated as § 409A deferred compensation could be paid.

The Regulations clarify and liberalize the application of these triggers:

- A plan may provide for payments to be made:
  - on the earlier (or later) of two or more permissible payment triggers – for example, on the earlier of separation from service or a change in control;
  - on different schedules, depending on whether the event trigger occurs before or after a specified date – for example, payment in installments upon retirement at or after age 65 but in a lump sum on any earlier termination;
  - at a time other than one of the permissible payment triggers, if the time can be objectively determined based on when a substantial risk of forfeiture lapses – for example, one year following the achievement of specified bonus targets; and/or
  - upon the plan's failing to satisfy the requirements of section 409A.

> *Observation:* Helpfully, the Regulations permit "back to back" arrangements (for example, involving a deferral arrangement between an investment fund and its advisory company that parallels a deferral arrangement between the advisory company and its employees) by providing that an employee's separation from service may be used to pay under both arrangements.

- A plan that specifies only the year of payment will not be treated as failing to specify a time. Instead, the plan will be treated as having specified January 1.

> *Observation:* This "January 1" rule does not mean that payment must actually be made on January 1. However, it does affect when any re-deferral election can be made. An election to push out deferrals beyond the original payment date must be made at least 12 months before the scheduled payment date.

- A plan can use any definition of disability that is at least as restrictive as the definition in § 409A, or it can specify that a Social Security determination will be used.

- Until further notice, the rules permitting distributions on a change in control of a corporation can be applied by analogy to changes in the ownership of a partnership. The Regulations also provide, helpfully, that hold-backs of stock-related compensation in connection with a change in control are permitted if the amounts are paid within five years and on the same terms as to shareholders generally.

Distributions Upon a Separation from Service

Amounts payable on a separation from service may include deferred compensation clearly subject to § 409A (for example, previously deferred salary) as well as amounts, such as severance, that may or may not constitute § 409A deferred compensation. For more information concerning severance, see below, "Separation Pay." For amounts treated as § 409A deferred compensation, the guidance contained in the Regulations includes the following:

- Leaves of absence shorter than six months or longer leaves where there is a right to reemployment do not constitute a "separation from service."

- A separation from service may occur even if the worker continues in the same position for a new employer – for example, where an employer sells a division to another company and the employees go with the sold division.

- On the other hand, the Regulations contain substance over form rules aimed at situations where a nominal break or continuation of the service relationship is really the opposite.

Observation: It is common practice in some companies to treat a terminated employee as a "consultant" for a period of time, even though the former employee may have few if any obligations to provide substantial services. Under the Regulations, a "consultant" of this type would be treated as having separated from service when the employment relationship terminated, and any delay in payment until the end of the "consultancy" could run afoul of the § 409A payment rules.

- "Key employees" of public companies must wait six months beyond separation from service to begin receiving deferred compensation payable on account of the separation from service. The Regulations permit "key employee" status to be determined on a look-back basis that should facilitate administration of this provision. They also permit flexibility in the payment of amounts required to be delayed under this provision.

Relief Provisions

The Regulations provide for leniency in certain situations when payment is not made at the scheduled time or upon the specified event.

- For purposes of § 409A, a payment is treated as made on a specified date if made within 2½ months thereafter (or, if later, by the end of the calendar year), with additional delay possible if a timely payment is not administratively feasible.
- A plan may provide for delayed payment to the extent necessary to prevent –
  - having a deduction for the payment limited by Code § 162(m);
  - a violation of the securities laws;
  - a violation of loan covenants; or
  - a breach of contract that would result in material harm to the employer.
- Payment can be delayed if calculation of the amount cannot be completed or if the payment would render the employer insolvent, regardless of whether the plan includes a provision for these circumstances.
- If the employer refuses to make payment at the specified time, the employee is generally treated as receiving payment at that time if he or she makes a good faith effort to obtain payment.

These exceptions should provide reasonable protection against unintended failures to comply with § 409A for reasons that are unrelated to the purposes of the statute.

SEPARATION PAY

Although § 409A by its terms excludes certain types of plans from its scope, severance is notably absent from the list of exclusions. The Regulations make it clear that "separation pay plans" are presumptively covered by § 409A but also contain exemptions that will apply in many cases.

- *Reservation of the Right to Terminate a Severance Pay Arrangement.* § 409A deferred compensation is never present unless the employee has a "legally binding" (if conditional) right to receive a payment in one taxable year and the amount is payable in another taxable year. Under many severance pay plans, the employer retains an unconditional right to terminate the plan at any time. In these plans, an employee generally would be treated as having a legally binding right to payment, if at all, only upon separation from service.

> *Why it matters:* For certain arrangements – for example, a severance deal negotiated with the employee at time of termination – the Regulations permit the payment terms to be fixed in the negotiations. This element of flexibility will be important to many employers.

- *Application of the Short-Term Deferral Rule.* According to the preamble to the Regulations, payments triggered by an involuntary separation from service that are paid shortly after the separation may qualify under the short-term deferral exception to § 409A (see above, "Short-Term Deferrals").

> *Why it matters:* For a "key employee" of a public company, separation pay that counts as § 409A deferred compensation could not begin to be paid until six months after separation. Coming within the short-term deferral exception makes it possible to pay the severance right away.

Observation: The Regulations do not automatically extend the same rationale or relief to "good reason" quit provisions, which are common in executive agreements. The status of "good reason" quit provisions remains unclear and may depend on how close the "good reason" is to a constructive termination by the employer.

- *Exemption for limited (middle-management/rank and file) involuntary and "window" separation pay programs.* The Regulations contain a helpful exemption from § 409A deferred compensation for many severance plans and "window" programs – although the exemption is unlikely to be of help for many executive arrangements. To qualify for the exemption:
  - The separation must be on account of an involuntary termination or participation in a window program, as defined.
  - The separation pay (determined without regard to excludable reimbursements; see below) cannot exceed an inflation-adjusted number (currently $420,000) or, if less, two times the employee's annual remuneration for the calendar year preceding the calendar of termination.
  - The separation pay must be paid no later than December 31 of the second calendar year following the year of the separation.

Why it matters: For properly structured arrangements, this relief provision effectively renders § 409A inapplicable to most employees – a helpful fact for employers that want to retain flexibility in structuring payments.

Observation: Terminations occur for many reasons. A company may want to accommodate a terminated employee by recording the termination as "by mutual agreement." This could cause the arrangement to fall outside of this "safe harbor" and be treated as nonqualified deferred compensation under §409A.

- *Collectively bargained plans.* Separation pay under a collectively bargained plan is generally exempt from § 409A.

- *Reimbursements.* The Regulations provide that reimbursement of certain actual expenses (the Regulations contain a list that includes, among others, a catch-all for de minimis payments) are not subject to § 409A if paid by the end of the second calendar year following the calendar year in which termination occurs.

> *Observation:* Many employment agreements provide for a taxable cash payment in lieu of health care or life insurance if those benefits cannot be provided by the employer. These make-up payments would likely not be exempt from § 409A.

SUBSEQUENT ELECTIONS

§ 409A permits "re-deferrals" – a pushing off of the payment date originally set for the payment of deferred compensation – if the change (i) may not take effect for 12 months, (ii) delays payouts for at least 5 years (with exceptions for death, disability and unforeseeable emergencies), and (iii) in the case of a fixed-date or other scheduled payment, is made at least 12 months prior to the first scheduled payment.

- For purposes of this rule, installment payments (other than life annuities) are treated as a single payment unless an arrangement provides at all times that the installment payments are to be treated as separate payments.

> *Observation:* Under the default ("single payment") treatment, an installment payout commencing on a particular date could be changed to a lump sum payment payable at least five years later – whereas, if each installment payment were treated separately, a lump sum payment five years after the original commencement date would be a prohibited acceleration of the later installments.

- The Regulations also treat a life annuity as a single payment. A change from one type of life annuity to another before payments begin, however, is not considered a change in the time and form of payment, provided the annuities are actuarially equivalent applying reasonable actuarial assumptions.

- The starting point under the Regulations is to treat as a "payment" each separately identified amount to which an employee is entitled to payment on a determinable date (for example, 10% of an account balance paid on January 1, 2008). So long as the initial deferral specified payments by reference to separate events (e.g., payment on the earlier of a separation from service or a fixed date), the re-deferral rules apply separately to each event. However, the addition of a payment event is itself subject to the re-deferral rules.

> *Observation:* The separate application of the re-deferral rule to each payment may be critically important. For example, if an initial election specifies payment on the earlier of a fixed date or a change in control, a later re-deferral can push off the fixed-date trigger without delaying any change-in-control-related payment. On the other hand, if the initial election specified a fixed date only, it would appear that any later addition of an "earlier of" provision would be impermissible unless the earliest payment date was at least five years later than the originally scheduled payment date.

CROSS-BORDER COMPENSATION

The Regulations contain complex rules that deal with cross-border deferred compensation, i.e., U.S. arrangements covering workers abroad (or nonresident aliens in the U.S.), and non-U.S. arrangements covering U.S. taxpayers.

> *Why it matters:* Multinational enterprises commonly move personnel from country to country and extend some home-jurisdiction benefits to employees of foreign subsidiaries. § 409A may affect both U.S. benefits for personnel working overseas (e.g., equalization benefits) and non-U.S. benefits covering personnel in the U.S.

- *Broad-based foreign retirement plans:* The Regulations effectively exempt from the scope of § 409A "broad-based foreign retirement plans" except as applied to U.S. citizens and green-card holders. For them, the exemption applies only if they are ineligible to participate in a U.S. qualified (or other tax-advantaged) plan and then only as to non-elective deferrals within specified dollar limits.
- *Deferrals that would not have been subject to U.S. tax when deferred:* In general, the Regulations exempt deferrals that would not have been includible in U.S. gross income when the legally binding right to the compensation first arose (or was no longer subject to a substantial risk of forfeiture, if later) – for example, deferrals covering non-U.S. individuals who retire to the U.S.
- *Other:* The Regulations exempt most social-security type plans of foreign jurisdictions, certain arrangements covered by treaty, and *de minimis* deferrals by non-resident aliens; they also provide transition relief for nonresident aliens who become residents. For U.S. taxpayers, they provide liberalized deferral rules for payments under tax equalization arrangements and coordination with the exclusion (currently $80,000) available to persons working abroad.

The Regulations *do not* provide special relief for a broad variety of common arrangements sponsored by non-U.S. employers that have historically included U.S. employees – for example, stock-based benefits payable on a deferred basis. They also do not contain guidance on the general § 409A prohibition against non-U.S. "funding" of nonqualified deferred compensation.

AGGREGATION RULES

Under the Regulations, as under earlier guidance, arrangements of the same type are treated as a single deferred compensation "plan" with respect to each participating employee. For example, assume that an employer maintains three account-based plans, each covering the same two executives. On these assumed facts, each executive would be treated as participating in only one plan – and a § 409A defect under any of the arrangements could result in adverse tax consequences to the executive under all of them.

- Earlier guidance divided plans into only three "types": individual-account plans, defined benefit plans, and arrangements fitting neither description (e.g. equity-based compensation). Separation pay arrangements were required to be assigned to one of these categories. The Regulations, helpfully, create a separate category for involuntary-separation and qualifying "window" separation pay arrangements. Because these separation pay arrangements are aggregated only with other such separation pay arrangements, a severance-pay compliance failure typically would not result in adverse § 409A consequences under other types of plans.
- Companies often maintain deferral plans for their outside directors. A defect under one company's plan will not taint a director's participation in an unrelated company's plan. Also, in those cases where an employee director participates in both a plan for non-employee directors and an employee plan, the two sets of plans would typically not be required to be aggregated.
- The Regulations require that plans be in writing, but a violation of this requirement in the case of one arrangement will not "taint" other arrangements of the same type.

Although § 409A applies as if each employee had a separate plan (or plans), some plan defects may adversely affect many participants – for example, a disqualifying provision in a plan document, or a pattern of repeated noncompliance with plan terms that is tantamount to the same thing.

> *Observation:* The aggregation rule will require vigilance in keeping track of the many deferral arrangements – some quite informal – that may cover the same individual.

EFFECTIVE DATE AND TRANSITION RULES

By statute, § 409A is generally effective as to compensation deferred, or previously deferred and first becoming vested, after December 31, 2004. In Notice 2005-1, the IRS provided transition rules which, among other things, permitted affected parties to amend plans at any time before 2006 in order to bring the plans into compliance with § 409A. The Regulations extend certain of the transition provisions through 2006. However, the Regulations leave other transition relief to expire on December 31, 2005, thus in many cases requiring employers to take some action before the end of this year.

- *Good Faith Compliance with Notice 2005-1.* The transition rules provided by Notice 2005-1 and by the Regulations protect a plan from violation of § 409A before it is amended to meet the applicable requirements only if the plan is operated in good faith compliance with the statute and Notice 2005-1 (or, as described below, the Regulations).
  - If any other guidance of general applicability is issued by the IRS with an earlier effective date than January 1, 2007, the plan must also comply with the guidance as of its effective date.
  - Taxpayers must also apply a good faith reasonable interpretation of the plan's terms to the extent not inconsistent with § 409A.
- *Compliance with the Regulations.* The Regulations are proposed to be effective January 1, 2007, and a plan is not required to comply with the Regulations (or final regulations) until that date.
  - However, compliance with the Regulations will constitute good faith compliance with the statute.
  - Where the Regulations are inconsistent with Notice 2005-1, a plan can satisfy the good-faith compliance requirement prior to 2007 by compliance with either.

> *Observation:* The Regulations do not appear to require that parties wishing to apply one provision of the Regulations during the transition period apply the Regulations in their entirety.

  - Application of the good faith compliance requirement is less clear where the Regulations impose requirements as to which both the statute and Notice 2005-1 are silent. If acting in good faith, a person should still be able to apply a reasonable interpretation of the statute and Notice.

Observation: Is it "good faith" to interpret general language in the statute and Notice in a manner that directly conflicts with a more specific provision of the Regulations, particularly if the Regulations describe the provision as a "clarification"? For example, neither the statute nor the Notice provides any hint of the position taken by the Regulations that stock options exempt from § 409A may be granted only on "plain vanilla" common stock (see above, "Stock-Based Awards"), yet the preamble to the Regulations characterizes the definition as a clarification. The answer *should* be that if an interpretation of the statute and Notice would have been a reasonable good faith interpretation if made before the Regulations appeared, the same interpretation will be treated as having been made reasonably and in good faith notwithstanding a contrary provision in the Regulations that is characterized as a clarification.

- *Extension of Time for Amendments and Elections.* The transition rules of the Regulations extend through 2006 the time for amending non-complying plans either to bring them into compliance with the § 409A requirements or to have them provide compensation that is not deferred compensation within the meaning of § 409A.
  - Plans may be amended before 2007 to provide for new elections as to time and form of payments.
  - However, an employee cannot in 2006 change elections in order to accelerate payments into 2006 or to defer payments that would otherwise be payable in 2006.
  - If the timing and form of a payment under a nonqualified deferred compensation plan was, as of October 3, 2004, controlled by an election under a qualified plan, the plan administrator may continue to operate the nonqualified plan in accordance with the qualified plan election for periods ending on or before December 31, 2006.

Observation: The Regulations require that § 409A arrangements be in writing. The deadline for amending plans to bring them into formal compliance with the § 409A requirements is also the deadline for reducing unwritten deferral arrangements to writing.

- *Time for Terminations and Cancellations Not Extended.* Notice 2005-1 had allowed participants to terminate plan participation or cancel existing deferrals during 2005, and had allowed employers to terminate plans and distribute assets during 2005, provided in each case that distributions had to be taken into income by the participants in 2005 or the later taxable year in which the amounts were earned and vested. This transition period has not been extended.
  - **Thus, employers who wish to terminate plans and distribute assets, and participants who wish to terminate participation or cancel existing deferrals, must take action before 2006.**
  - This same requirement applies to grandfathered plans (plans in effect prior to 2005 and not modified after October 3, 2004). Cash-outs of such plans must take place by December 31, 2005.

> *Observation:* If a grandfathered plan is amended to give a participant a choice whether to terminate participation or continue in the plan, the amendment will be a modification. The result will be that the plan is no longer grandfathered, and if the plan does not comply with § 409A the participant will effectively have no choice but to terminate participation or submit to change in the plan's terms to bring them into compliance.

- *Transition Period for Stock Rights.* Non-complying stock rights may be replaced with stock rights that comply as of their date of grant. The period for making such a replacement has been extended through 2006. Thus, a stock option that does not qualify for exemption from § 409A because it was granted at a discount may be amended at any time before 2007 to increase the exercise price to an amount at least equal to the fair market value of the stock at the time the option was granted.

Observation: This extension of the transition period does not apply to an exercise or cash-out of non-complying stock rights. Thus, non-complying stock rights must either be exercised or cashed out in 2005 or amended before 2007 to comply (and, if rights are amended during 2006 the participants must not, in 2006, be given cash or property that is vested in 2006). This means that, if the exercise price of a stock option is to be increased in order to bring the option into compliance, the participant can be compensated for the lost discount only if the amendment to the option is made, and the compensation is paid to the participant, before January 1, 2006, or, if the amendment occurs in 2006, the compensation for the lost discount is not payable until after 2006.

- *Initial Deferrals.* Notice 2005-1 had allowed initial elections with respect to 2005 compensation to be made by March 15, 2005. The Regulations do *not* provide additional time for such elections.

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