Final Regulations Issued under Section 409A

Treasury and the IRS today issued long-awaited final regulations under Code § 409A. The regulations make a number of changes to existing guidance that will affect the way employers and other service recipients structure compensation arrangements. A few selected highlights:

- Stock rights. The final regulations helpfully allow companies to grant options and SARs on a wider range of common stock than under previous guidance. The requirement that qualifying common stock be of the most valuable class has been eliminated. However, common stock with a preference right (other than as to stock distributions or liquidating distributions) does not qualify.
  - *Service recipient.* Stock rights may now be granted on qualifying stock of the employer or of any corporation above the employer in a chain of control. Awards on the stock of other companies in a controlled group (*e.g.*, brother-sister companies) appear not to be permitted under these rules.
  - *Existing awards.* Existing awards (*i.e.*, those granted before April 10, 2007) that were granted in good-faith, reasonable reliance on prior guidance need not conform to the new rules. (However, any modification of those awards that constituted a new grant could be problematic.)
- "Good reason"-based severance. A new rule permits a qualifying "good reason" quit to be treated as a payment upon an involuntary separation and thus eligible for an exemption from the 409A rules. This change eliminates a source of considerable uncertainty in the drafting of employment agreements and severance plans. Many employers will want to consider using the safe-harbor definition of "good reason" that is included in the final regulations.
- Back-to-Back Arrangements of Hedge Fund Advisors. The final regulations generally preserve the existing relief for back-to-back deferral arrangements common among hedge funds, their advisors, and the advisors' employees or members. However, Treasury and the IRS rejected requests for a blanket rule permitting acceleration of payment to employees or members of the advisor upon termination of the advisor's relationship with the underlying fund group – although they will continue to study the matter.
- Anti-Abuse Rule. The final regulations include a catch-all in the definition of "nonqualified deferred compensation plans" that gives the IRS discretionary authority to treat a plan as subject to 409A if a principal purpose of the plan is to achieve a result inconsistent with the purposes of section 409A.
- Reserving Judgment. The final regulations are still not comprehensive. In particular, the Treasury and the IRS reserve on issues relating to the application of 409A to partnership arrangements and provide no guidance on 409A's funding rules (including the prohibition against certain off-shore funding arrangements) or, in general, on the computation of amounts subject to adverse tax consequences under 409A where a plan fails to comply with 409A.

We hope to provide a more comprehensive overview of the new rules in the near future. In the meantime, please feel free to direct any questions to any member of the Tax & Benefits Department.