Compensation of Founders and Key Employees of Emerging Companies
After The Enactment of Section 409A

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The American Jobs Creation Act of 2004 created Internal Revenue Code Section 409A which governs the taxation of nonqualified deferred compensation. The IRS issued transitional guidance with respect to Section 409A late last year, and within the last three weeks, issued proposed regulations totaling 238 pages.

This outline provides an overview of Section 409A and discusses the impact of the new rules on the compensation of founders and key employees of emerging companies. The discussion is based on IRS Notice 2005-1 (published December 20, 2004) and Prop. Reg. §1.409A-1 (published October 4, 2005). The IRS is expected to issue additional guidance in the future.

I. Overview of Section 409A

A. Why was Section 409A enacted? Section 409A was enacted to prevent the manipulation and abuse of deferred compensation by executives (think Enron, MCI Worldcom, Global Crossing, etc.).

B. When did Section 409A take effect?

1. Section 409A became effective January 1, 2005, and applies to compensation that is earned or vested after December 31, 2004.

2. Employers have until December 31, 2006 to make the necessary amendments to bring deferred compensation arrangements into compliance with Section 409A. In the meantime, the arrangements must be operated in good faith compliance with the new rules.

3. While the date for documentary compliance was extended, certain other important transition rules were not, and employers may need to act by 12/31/2005 to avoid inadvertently triggering the Section 409A sanctions.

4. The effective date provisions and transition rules applicable before January 1, 2007 are discussed in more detail later.

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C. What kinds of limitations does Section 409A impose? The new rules primarily affect elections to defer the receipt of compensation and elections regarding the time and manner in which deferred compensation is paid. The rules also limit offshore funding arrangements and the use of so-called rabbi trusts to fund deferred compensation where the funding is triggered by changes in an employer's financial health.

D. What is the effect of failure to comply with the Section 409A rules?

1. If a nonqualified deferred compensation arrangement fails to meet the requirements of Section 409A, then:
   a) All untaxed amounts under the arrangement are taxed in the year the failure occurs, or if later, when the deferred compensation is no longer subject to a substantial risk of forfeiture.
   b) A 20% excise tax is imposed on the amount includible in gross income.
   c) An additional excise tax is imposed, equal to the underpayment rate plus 1%.
      (1) The underpayment rate is the amount of interest that would have been due on the underpayment of tax (if the deferred compensation had been included in income when first deferred, or if later, when it was no longer subject to a substantial risk of forfeiture).
      (2) The requirement to compute the underpayment for years past will require knowledge of the tax laws (and tax rate) in effect for prior years as well as tracking the underpayment rate for prior years.

2. If an operational failure occurs, only the person affected would be subject to current taxation and the excise tax.

3. If the plan contains impermissible provisions, all persons covered by the plan could be subject to current taxation and the excise tax.
E. Impact of Section 409A on Other Code Provisions and Traditional Tax Doctrine

1. Section 409A does not affect common law tax doctrine. The concepts of constructive receipt and economic benefit continue to apply. In addition, the provisions of the Internal Revenue Code that specifically deal with equity compensation or other compensatory transfers of property continue to apply.

2. Section 409A does not affect the provisions of ERISA that apply to deferred compensation.
   a) If the payment of compensation is deferred until termination of employment or beyond, the deferred compensation (including a SAR or phantom stock award) constitutes an “employee pension benefit plan” for purposes of the Employee Retirement Income Security Act (ERISA). However, amounts payable to executives may qualify as a “top hat” plan that is exempt from most ERISA requirements.
   b) A top-hat plan is an unfunded plan maintained by an employer primarily to provide deferred compensation for a “select group of management or highly compensated employees.”
   c) Top-hat plans are exempt from most of ERISA’s provisions except for the requirement that a claims procedure be provided under the plan and except for certain reporting and disclosure requirements. To meet the reporting and disclosure requirements, the administrator of a top hat plan must file only a single statement with the DOL and provide the DOL with the plan documents if requested.

II. Who is affected by Section 409A?

Section 409A affects both service recipients and service providers.

A. Who is a "service provider"? For purposes of Section 409A, the person or entity performing the services is referred to as the "service provider."

1. A "service provider" includes both employees and non-employees (e.g. directors, consultants and independent contractors).
2. It also includes corporations, S corporations, partnerships, LLCs, and personal services corporations.

3. Exceptions:
   a) **Accrual basis service providers.** Section 409A does not apply to a service provider using the accrual method of accounting for Federal tax purposes.
   
   b) **Multiple service recipients.** Section 409A does not apply to an independent contractor arrangement if:
      
      (1) The independent contractor and service recipient are unrelated.
      
      (2) The services are provided in a capacity other than an employee or director of a corporation.
      
      (3) The independent contractor provides significant services to two or more unrelated service recipients.
         
         (a) An independent contractor will be deemed to be providing significant services to more than one service provider if no more than 70% of the service provider's total revenue is attributable to any single service recipient.
      
      (4) The services do not involve "management services."

B. **Who is a "service recipient"?** For purposes of Section 409A, the person or entity for whom the services are performed is referred to as the "service recipient."

1. The term "service recipient" includes all forms of businesses, including corporations, S corporations, partnerships (general, limited, LLPs), limited liability companies, and sole proprietorships.
   
   a) Section 409A applies to for profit, tax-exempt and governmental employers.

2. The determination of the "service recipient" is made based on the qualified plan "controlled group" rules in IRC Section 414(b) and (c).
a) **Parent/Subsidiary** – A parent and a subsidiary (including a lower tier subsidiary) are considered a single "service recipient" as long as the parent directly or indirectly owns 80% or more of the subsidiary.

b) **Brother/Sister** – A brother/sister group will be a single service recipient if the same 5 or fewer persons have a controlling interest (at least 80%) in each entity and, taking into account only overlapping common ownership, the same 5 or fewer persons have effective control (i.e., more than 50% control) of each entity.

### III. Definition of Nonqualified Deferred Compensation

#### A. Deferred compensation for purposes of Section 409A.

1. For purposes of Section 409A, deferred compensation is any compensation that is earned in one year and includible in income in a later year. Any type of taxable compensatory payment is covered, whether or not paid pursuant to a plan, arrangement or agreement and regardless of the number of persons covered.

   a) Section 409A applies to both elective and non-elective forms of deferred compensation.

   b) The proposed regulations contain language that could be read as extending the Section 409A sanctions to certain non taxable benefits.

   c) In analyzing the extent to which Section 409A applies, two questions must be answered: (1) does the service provider have a legally binding right to the compensation, and (2) if so, does the legally binding right provide for a deferral of taxable compensation?

2. Compensation is considered to be earned when the service provider has a “legally binding right” to the compensation.

   a) A “legally binding right” to the compensation does not exist if the deferred compensation may be unilaterally reduced or eliminated by the service recipient.

   (1) The service recipient must have the unilateral right to reduce or eliminate the deferred compensation. If the right is subject to a
condition, the requisite discretion does not exist.

(2) If the discretion to reduce or eliminate the deferred compensation lacks “substantive significance”, then the discretion will be ignored and the executive will be considered to have a legally binding right to the deferred compensation. The extent to which the negative discretion lacks “substantive significance” is based on facts and circumstances. However, the discretion will lack “substantive significance” if the executive has effective control over the person retaining the discretion, has effective control over any portion of the compensation of that person, or is a family member of that person.

b) A service provider has a legally binding right to deferred compensation even though it is subject to a condition (such as a substantial risk of forfeiture).

3. For purposes of Section 409A, deferred compensation does not include compensation that is "deferred" until the lapse of a substantial risk of forfeiture. For example, an employee is promised a bonus tied to a percentage of profits in year 1 if he/she remains employed through the end of year 3. While the employee has a legally binding right to the compensation in year 1 (subject to the condition that the employee remains employed through year 3), the bonus is not vested until the end of year 3. If the bonus is paid when it vests, the bonus is not considered deferred compensation for purposes of Section 409A.

a) A substantial risk of forfeiture exists if entitlement is conditioned on the performance of substantial future services by any person (e.g., the employee must remain employed for a period of 3 years and will forfeit the compensation if he/she terminates employment before that time).

b) A substantial risk of forfeiture also exists if entitlement is tied to the occurrence of a condition related to the purpose of the compensation, such as the attainment of a specific goal (e.g., the attainment of a specified level of earnings). Based on this definition, severance that is only payable on involuntary termination of
employment would not be vested until termination occurs.

c) Merely refraining from the performance of services (as in the case of a non-compete) is not sufficient to constitute a substantial risk of forfeiture for purposes of Section 409A.

B. What are some common types of deferred compensation covered by Section 409A?

1. SERPs. A supplemental executive retirement plan is the type of "traditional" nonqualified deferred compensation targeted by Section 409A.

2. Excess plans (e.g., plans that provide supplemental "qualified plan" benefits on compensation in excess of the IRC Section 401(a)(17) limit ($210,000 for 2005) or benefits in excess of those permitted under IRC Section 415).

3. 401(k) wraps.

4. Bonus and incentive deferral plans.

5. Elective deferral plans (i.e., elective deferrals of "regular" compensation).

6. 457(f) deferred compensation (i.e., "ineligible" deferred compensation for tax-exempts and governmental employers).

7. Separation payments (i.e., severance benefits) (Note: As discussed in more detail below, the proposed regulations contain special rules that would remove many severance arrangements from the reach of Section 409A).

8. Equity Compensation. Discounted stock options, discounted stock appreciation rights (SARs), unit or member appreciation rights (partnerships and LLCs), restricted share units (RSUs), phantom stock and any other form of equity compensation (other than a transfer of property covered by Section 83 that does not include a deferral provision).

   a) While "non-discouted" options and SARs (i.e., options and SARs issued at FMV are not covered, discounted options and SARs are covered).
b) Restricted stock grants subject to Section 83 are not covered, unless the grant includes some type of deferral right.

c) While the proposed regulations did not address the application of 409A to equity compensation in partnerships and LLCs, the provisions of Notice 2005-1 continue to apply to these interests.

(1) Profits interests which are not taxed when issued are not treated as deferred compensation.

(2) Capital interests can be treated in the same manner as stock (presumably taking into account the provisions of the proposed regulations).

(3) Pending further guidance from the IRS, Section 707(c) guaranteed payments are considered deferred compensation for purposes of Section 409A if payment is made more than 2 1/2 months after the year in which the payment vests.

d) The application of IRC Section 409A to equity compensation is discussed in more detail below.

9. Taxable fringes and other perks involving a deferred payment – including taxable benefits frequently found in executive employment agreements.

a) 409A deferred compensation includes:

(1) any taxable fringe payable more than 2 1/2 months after the close of the year in which it is earned and vested.

(2) taxable reimbursements (such as taxable reimbursement for tax planning or tax preparation, or other similar amounts) that are paid after the close of the employment year.

(a) If the reimbursement is conditioned on the executive's employment on the reimbursement date, the right to the reimbursement would not be considered to be "vested" until payment is made
(and would not be considered deferred compensation).

(b) In cases where the reimbursement is not linked to employment on the reimbursement date, a taxable reimbursement of expenses after the close of the employment year would be considered deferred compensation (if paid more than 2 1/2 months after the close of the year).

(c) While the simple answer may be to make sure the payment is conditioned on continued employment, an executive may not be amenable to such a provision.

C. Types of deferred compensation not covered by IRC Section 409A

1. Section 409A does not apply to:

   a) Short-term deferrals (i.e., compensation paid within 2 1/2 months after the close of the year in which it is earned or no longer subject to a substantial risk of forfeiture) – discussed in more detail below.

   b) Certain separation pay (discussed in more detail below).

   c) "Qualified employer plans", which are defined as:
      
      (1) Tax qualified retirement plans under Section 401(a).
      
      (2) Tax qualified annuities under Section 403(a).
      
      (3) Section 403(b) tax sheltered annuities and custodial accounts.
      
      (4) Eligible deferred compensation plans under Section 457(b) (for both tax-exempt and governmental employers).
      
      (5) Simplified employee pension or simple retirement accounts.
(6) Governmental excess plans under Section 415(m).

d) Certain foreign plans

(1) Includes foreign plans involving contributions excludable from Federal income tax pursuant to a bilateral tax treaty.

(2) Broad based foreign retirement plans covering:

(a) Nonresident aliens.

(b) U.S. citizens or resident aliens (but only up to the contribution/benefit limits applicable to U.S. qualified retirement plans).

e) Non-discounted options and SARs (discussed in more detail below).

f) Employee stock purchase plans.

g) Incentive stock options.

h) Transfers governed by Section 83.

i) A "bona fide" vacation leave, sick leave, compensatory time, disability or death benefit plan.

(1) HSAs and Archer MSAs are not considered deferred compensation.

(2) Medical benefits (including medical reimbursements) covered by IRC Section 105 and 106 are excluded.

2. Short-Term Deferrals

a) Compensation that, by its terms, is paid out within 2 1/2 months following the close of the taxable year in which it is earned (or if later, the year when it vests) is not treated as deferred compensation for purposes of IRC Section 409A. The short-term deferral rule provides an important means of avoiding the application of Section 409A.
(1) Unless payment is delayed due to an unforeseeable event (discussed below), the compensation must be paid by the 15th day of the third month following the year in which it is earned or vested. For example, if a bonus is earned and vested on November 1, 2006, it must be paid by March 15, 2007.

(2) The short-term deferral rule cannot be used to accelerate deferred compensation payments.

(a) Thus, for example, if an agreement provides for payment 24 months after vesting, but payment is actually made within 2 1/2 months after the year in which the compensation vests, the short-term deferral rule would not apply and the payment would be viewed as an impermissible acceleration triggering the 20%+ excise tax.

(3) The arrangement does not have to specify a payment date within the short-term deferral window. Where a payment date is not specified, the short-term deferral exception will apply if the payment is actually made by the close of the 2 1/2 month window. However, if payment is made after this date, it will be treated as deferred compensation and automatically trigger the 20%+ excise tax (unless the delay is attributable to an unforeseeable administrative or solvency issue discussed below).

(4) If, on the other hand, the arrangement specifies a payment date within the 2 1/2 month window, but payment is not made by the 15th day of the third month (and the delay in payment is not due to an unforeseeable administrative or solvency issue), then the payment would be considered deferred compensation. However, the excise tax could be avoided by:

(a) Ensuring payment is actually made within the same calendar year as the fixed payment date, or
(b) Taking advantage of other rules that permit delays in payment (such as where the obligation to make the payment is disputed).

(5) For this reason, all arrangements that contemplate using the short-term deferral exception should specify a specific payment date within the 2 1/2 month window.

b) The short-term deferral rule can be applied on the basis of the taxable year of the service provider (i.e., employee) or the service recipient (i.e., the employer). Thus, for example, if the employer is on a August 31st fiscal year and an individual employee (taxed on a calendar year basis) earns a bonus on November 1, 2006, the bonus will not be considered deferred compensation as long as it is paid out by November 15, 2007 (2 1/2 months after the close of the employer's fiscal year).

c) If the payment is delayed beyond the 15th day of the third month due to unforeseeable events, the short-term deferral rule will still apply. Unforeseeable events include:

(1) It is administratively impractical to make the payment within the 2 1/2 month window.

(2) Payment would jeopardize the solvency of the service provider (i.e., employer).

Note: the administratively impracticality or solvency issue must have been unforeseeable on the date the legally binding right to the compensation arose.

D. Separation Pay.

1. For purposes of Section 409A, "separation pay" is defined as "any amount of compensation where one of the conditions to the right to payment is a separation from service....."

   a) Separation pay includes:

      (1) voluntary or involuntary separations.

      (2) reimbursement of expenses.
(3) any taxable benefits.

2. In order for 409A to apply to separation pay, the employee has to have a vested right to the payment of compensation in one year, that is paid in another.

a) In most cases involving severance that is payable upon an involuntary termination of employment, the employee does not have a vested right to separation pay until involuntary termination occurs.

   (1) Separation payments completed within 2 1/2 months after close of the termination year would not constitute deferred compensation. However, if severance extends beyond the short-term deferral date, the payment will be treated as deferred compensation subject to 409A.

   (2) Note: If a key employee’s severance is payable within the 2 1/2 month short-term deferral period, the payment will not be considered deferred compensation and the restriction prohibiting payments within 6 months of a severance from employment would not apply. However, if the severance extends beyond the short-term deferral period, payments relating to separation must be delayed for 6 months.

3. Unless specifically excluded from the definition of deferred compensation, separation pay that does not qualify for the short-term deferral exception is subject to IRC Section 409A.

   a) Subjecting severance to IRC Section 409A means that the timing of the severance needs to be "hard wired" in the employment agreement, and it would be difficult, if not impossible, to change the timing of the payments. For example, if payments are scheduled to be made monthly over a period of 36 months, an agreement to convert the payment to a single lump sum payment would violate the anti-acceleration rule. Similarly, if the agreement called for a lump sum payment, an election to take monthly payments over a period of more than 12 months would have to be made at least 12 months prior to separation and the
payment would have to be deferred for a period of at least five years.

b) A potentially bigger problem for separation pay subject to Section 409A deals with reimbursements and the continuation of fringe benefits following termination. In order to comply with Section 409A, the amount deferred and time of payment must be objectively determinable at the time of termination. In many cases, the amount and payment date cannot be determined until some future date. Examples include:

(1) **4999 Gross-Up.** If an employment agreement provides for payment of the golden parachute excise tax imposed by Section 4999 (and a gross-up to cover the additional tax on the payment), the extent to which the tax has been triggered may not be known for some time after a change in control event has occurred. Typically, the gross-up clause calls for reimbursement within a specified time after the tax is assessed (subject to the right of the company to contest the imposition (or amount) of the tax).

(2) **Taxable Reimbursement.** In the case of an agreement that provides for reimbursement of certain expenses incurred during the severance period (such as tax preparation), neither the amount nor timing of the payment is determinable when the executive's contractual right to the payment vests.

c) If separation pay is subject to bona fide arms length negotiation at the time of separation, the election as to the form and time of payment can be made anytime prior to the time the employee has a legally binding right to the payment.

(1) This rule would permit the negotiation of a severance package at the time of separation (even if it otherwise constitutes deferred compensation for purposes of Section 409A).

(2) However, it does not permit the re-negotiation of the timing of severance payments to which an employee has a current contractual right.
4. The following types of separation pay are excluded from the definition of deferred compensation for purposes of Section 409A.

a) Collectively-bargained separation pay arrangements.

b) Involuntary Termination or Window Payments. Payment made in connection with an involuntary separation from service, or voluntary participation in a “window” program, are not considered deferred compensation if:

   (1) All payments are completed by December 31\textsuperscript{st} of the second calendar year following year of separation.

   (2) The payments (excluding certain reimbursements) do not exceed the lesser of two times annual compensation for the preceding calendar year or the qualified plan compensation limit under IRC Section 401(a)(17).

      a) For 2005, the 401(a)(17) limit is $210,000, so the total separation pay/window payment could not exceed $420,000 (based on 2005 limits).

      b) Compensation is defined by reference to Treas. Reg. §1.415-2(d)(2). For this purpose, compensation consists of:

         (i) Wages, salaries, and other amounts received for personal services to the extent that the amounts are includible in gross income.

         (ii) Earned income of a partner or other self-employed person.

      c) Compensation does not include:

         (i) contributions or benefits under any qualified or nonqualified retirement plan, deferred compensation plan, welfare
benefit plan or fringe benefit plan; or

(ii) compensation resulting from the exercise or cancellation of stock options or stock awards or the disposition of the underlying stock.

(3) While the separation pay exclusion is helpful, the provision has several significant limitations:

(a) Under the proposed regulations, an involuntary termination does not include a constructive termination or resignation for good reason.

(b) In the case of senior executives making over $210,000, severance will typically exceed two times the 401(a)(17) compensation limit, even if severance is based on base pay.

(c) If 409A applies, fringes paid during severance could be a real problem because of the need to have an objectively determinable amount and payment date.

c) **Certain reimbursements and other payments.** Certain payments and reimbursements of other benefits provided to an executive who has separated from service will not be considered to provide for the deferral of compensation, as long as they are incurred and paid by December 31st of the second calendar year following the calendar year in which the separation from service occurs.

(1) This applies to reimbursements that would otherwise be excludible from income (ignoring any adjusted gross income limits), or that would otherwise be deductible by the service provider as a reasonable business expense, reasonable outplacement or moving expenses, medical expenses or other payments that do not exceed $5,000 in the aggregate.
(2) The exception applies only for two years, which once again raises issues about how reimbursed expenses that last for longer periods of time will be handled.

E. Plan Aggregation

1. In applying Section 409A (including the sanction provisions), all plans of the same type are aggregated:

2. Plans are aggregated by the following categories: All individual account plans; all non-account plans; all equity plans; and all separation pay/window plans.

IV. Application of 409A to Equity Compensation

A. ISOs and Employee Stock Purchase Plans.

1. Section 409A does not apply to ISOs. However, Section 409A would apply to any modification that results in loss of ISO treatment (unless the option, after modification, would still be covered by the exception for non-discounted options).

2. Section 409A does not apply to IRC Section 423 employee stock purchase plans.

B. Nonqualified Stock Options.

1. Non-discounted stock options will not constitute deferred compensation, provided that:

   a) The exercise price is never less than the fair market value of the underlying stock on the grant date.

   b) The number of shares subject to the option is fixed on the grant date.

   c) There are no deferral features (i.e., the stock is issued within 2 1/2 months after the close of the year in which exercise occurs).

   d) The transfer or exercise of the option is subject to tax under the principles of Section 83 (i.e., the option is subject to tax on exercise (or if the option itself has a readily ascertainable value (which is extremely rare), the option is subject to tax when it is transferable and no longer subject to a substantial risk of forfeiture).
e) Common stock of the "service recipient" is used for the option.

2. Only common stock of the "service recipient" can be used for non-discounted options and SARs that are intended to fall outside the scope of Section 409A. If other stock is used, the proposed regulations take the position that Section 409A would apply.

a) What is common stock for purposes of Section 409A?

(1) Common stock refers to the common stock of the service recipient that is traded on an established securities market, or if common stock is not traded, common stock that has the highest aggregate value of any class of common stock of the service recipient (or non-voting stock which is similar to such common stock).

(2) An ADR can qualify.

(3) If the "service recipient" has publicly traded common stock, the publicly traded stock must be used. Non-traded stock of a subsidiary would not qualify. This requirement effectively prevents a public company from granting an equity interest in the non-traded stock of a subsidiary without subjecting the grant to Section 409A.

(4) Preferred stock cannot be used. The IRS was concerned that preferred stock could be used as means of providing deferred compensation.

(5) The stock cannot be subject to a mandatory repurchase restriction or a put or call right that is based on a measure other than fair market value.

(a) A lower repurchase price linked to a vesting or "lapse" restriction would not affect the status of the stock as common stock for purposes of Section 409A (e.g., the stock could be repurchased at less than FMV upon termination prior to vesting).
b) Who is the service recipient?

(1) The determination of the service recipient is made using the qualified plan controlled group rules in IRC Section 414(b) and (c).

(2) However, the employer can elect to determine the "service recipient" under IRC Section 414(b) and (c) using a 50% threshold (instead of the 80% threshold applicable for other purposes).

(3) In the case of a parent/subsidiary, this would mean that a parent and 50% owned subsidiary would be a single service recipient.

(4) In the case of a brother/sister group, this would mean that the controlling interest test is applied using a 50% threshold (instead of the 80% threshold).

(5) Also, the determination of "service recipient stock" can be made using a 20% threshold in lieu of the 80% threshold, if the grant is based on legitimate business reasons.

   (a) For example, an employee is transferred to operating joint venture in which the employer has a 20% interest. The employer could issue an option to the employee, and the underlying stock would be deemed to be "service recipient stock."

(6) An election to use the 50% or 20% threshold would have to apply to all compensatory stock rights.

(7) Investment vehicles are not considered service recipients, except with respect to persons actually providing services to the investment entity.

(8) In the case of a corporate transaction, stock of a successor can be substituted for the original service recipient stock.
3. **Stock Options Subject to 409A**
   
a) If an option is subject to Section 409A, (e.g., a discounted option, or an option issued by a public company using non-traded stock), then the option could only be exercisable in connection with a permitted distribution event. If the option is exercisable prior to a permitted distribution event, the exercise would trigger the 409A sanctions.

b) Note that if a non-409A compliant option must be exercised (or lapse) within 2 1/2 months after the close of the year in which the option vests (i.e., the short-term deferral period), it would not be subject to Section 409A.

C. **Stock Appreciation Rights (SARs).**

1. SARs will not constitute deferred compensation if:

a) The amount payable on exercise is never greater than the difference between the fair market value of the underlying stock on the exercise date and the fair market value of the underlying stock on the grant date.

b) The number of shares subject to the SAR are fixed on or before the grant date.

c) Common stock of the "service recipient" is used for the SAR.
   
   (1) If the "service recipient" has publicly traded common stock, the publicly traded stock must be used. Non-traded stock of a subsidiary would not qualify.

d) There are no deferral features (i.e., the appreciation is paid (in cash, stock or a combination of cash and stock) within 2 1/2 months after the close of the year in which exercise occurs.

2. The proposed regulations exempt SARs granted with respect to both privately-held and publicly-traded stock, as long as these requirements are met.
3. The rules regarding service recipient stock and the
determination of fair market value that were discussed under
options, also apply to SARs.

4. The ability to issue SARs without triggering Section 409A is
an important feature, especially in light of the new
accounting rules relating to stock based compensation.

5. If a SAR is subject to Section 409A, payment can only be
made upon a permitted distribution event.
   a) The SAR could be automatically exercised as of a
      permitted distribution event (such as a fixed date after
      exercise (e.g., 5 years) or on separation from
      service).
   b) If the SAR had to be exercised (and payment made)
      within 2 1/2 months after the close of the year in
      which it vests, then the SAR would not be subject to
      409A.
   c) A SAR could also be structured so that it could be
      exercised at any time during the term of the SAR, but
      payment of the amount due would only be made upon
      a permitted distribution event. If payment were
      delayed, earnings could be credited to the amount
      payable (so that the employee is made whole for the
      delay in payment).

D. Restricted Stock.

1. The transfer of restricted stock is not subject to 409A,
regardless of whether a Section 83(b) election has been
made to include the value of the restricted stock in income.

2. However, a legally binding right to receive stock at some
future date would constitute deferred compensation (unless
the transfer occurs within 2 1/2 months after the close of the
year in which the right vests).

E. RSUs, Performance Shares, Phantom Stock.

1. RSUs and performance shares typically involve a promise to
grant a specified number of shares in the future (or pay their
cash equivalent) upon satisfaction of performance criteria,
longevity, or some combination of the two.
2. Phantom stock is similar to RSUs and performance shares, except that payment is generally settled in cash instead of shares.

3. The "promise" to make the grant or payment is unsecured (and in the nature of deferred compensation). Hence, Section 409A would apply.

4. In most cases, the RSUs and performance shares awards are granted or paid at the time the performance or longevity requirements are met (i.e., when the RSUs vest). If payment is made at the time of vesting (or within 2 1/2 months after the close of the year in which the award vests), Section 409A would not apply (because there is no deferral of a vested right).

5. If a vested grant or payment is deferred beyond the short-term deferral period, the Section 409A requirements must be met.

6. In most cases, this simply means that the distribution provisions must be "hard wired" into the grant agreement or any deferral election must be made when the grant is made.

F. Valuation of Stock. The determination of the fair market value of the stock is made in accordance with the following rules:

1. If the stock is publicly traded, the determination of fair market value is based on the trading price.
   a) The value of the stock can be determined using any reasonable method, provided the method is based on actual reported stock transactions and the method is consistently applied. Acceptable measures include the closing price on the grant date (or the day before the grant date), the opening price after the grant date, an average of the selling price during a specified period of up to 30 days before or after the grant date.
   (1) If an averaging method is used, the terms of the grant must be established before the beginning of the averaging period (i.e., a look-back period is not permitted).

2. Valuation for privately-held companies can be determined by the reasonable application of a reasonable valuation method.
a) The reasonableness of the valuation method is determined on a fact and circumstances basis.

b) Factors taken into account include:

(1) value of assets (tangible and intangible).

(2) present value of future cash flow.

(3) value of comparable businesses (as established by the trading price of publicly traded stock or based on an arm's length transaction).

(4) control premium or discount for minority interests and/or lack of marketability.

c) The valuation must be based on all available material information.

d) Use of a valuation method for other unrelated purposes is a factor in establishing reasonableness.

3. The following valuation methods are presumed to be reasonable (provided the method is consistently used). The IRS can overcome the presumption upon a showing that the valuation method was grossly unreasonable.

a) Independent appraisal – An independent appraisal within 12 months of the relevant transaction.

(1) The appraisal standards applicable to ESOP valuations apply.

(a) The appraiser must hold himself/herself out as an appraiser and perform appraisals on a regular basis.

(b) The appraiser must be qualified to make the appraisal.

(c) The appraiser must be unrelated.

b) Formula price – A formula valuation that meets the requirements of a non-lapse restriction under IRC Section 83.
(1) According to the proposed regulations, the formula price (e.g., book value or a reasonable multiple of earnings) would have to apply to not only the grant, but to any transaction in which the service recipient is either the purchaser or seller of the stock, as well as all noncompensatory valuations of the stock (e.g., loan covenants).

(2) It is not clear what impact the cancellation of the formula restriction would have on the grant (for example upon the sale of the business). Under §83, a noncompensatory cancellation does not result in the recognition of income.

c) Special Rule for Start-Up Valuation – A reasonable, good faith written valuation of illiquid stock of a start-up corporation that takes into account the valuation factors discussed above.

(1) A start-up corporation is defined as a corporation that has been in existence for less than 10 years and that does not have any publicly traded securities.

(2) The stock cannot be subject to a put, call or other obligation of the service recipient to purchase the stock (other than a right of first refusal).

(3) The special start-up valuation rule does not apply if the service provider or service recipient can reasonably expect to undergo a change in control event or IPO in the next 12 months.

(4) The valuation has to be performed by someone with significant knowledge and experience or training in performing similar valuations.

(5) The person performing the valuation can be an "insider."

V. What rules does Section 409A impose regarding the form and timing of compensation deferrals?

A. Timing of Deferral Elections.

a) Elections to voluntarily defer compensation must be made before the start of the year in which services for the compensation are performed. (e.g., an election to defer compensation for services performed in 2006 must be made by December 31, 2005.)

(1) The election must be made prior to the start of the service provider's taxable year.

(2) The timing requirement applies even if the service provider is not vested in the amount deferred.

(3) "Evergreen" elections are permitted (i.e., an election for one year remains in effect for all succeeding years unless terminated or changed by the executive).

   (a) Any change to the election must be made by December 31st.

   (b) After December 31st, the election must be irrevocable with respect to the following year.

2. Special rules:

a) Newly-eligible participants.

   (1) A new participant can make an election within 30 days after becoming eligible. However, the election can only apply to compensation for services performed after the election.

   (2) In the case of compensation that is earned based on a specific performance period, such as annual bonus, the election with respect to the performance compensation needs to be prorated based on the number of days remaining in the performance period after the election, compared to the total number of days in the performance period.

   (3) Note that for purposes of determining whether a participant is "newly-eligible" (and thus eligible for the 30-day rule), the plan aggregation rules apply. Thus, if the service provider already participates in another
deferred compensation plan of the same type, a participant would not be considered "newly eligible."

b) Mid-year awards of forfeitable amounts.

(1) The proposed regulations provide a rule for mid-year awards involving forfeitable rights. Because of the plan aggregation rules, a service provider that is already participating in a plan of the same type may be precluded from making a mid-year initial deferral election absent this rule.

(a) Example: A participant already participates in an account plan and became eligible for another (separate) account plan mid-year. The 30 day rule for newly eligible participants would not apply.

(2) Under a special rule, the service provider can elect to defer a new (mid-year) award if (1) the award is subject to a forfeiture condition requiring more than 12 months of service, and (2) the election is made within 30 days of the award.

(3) This ensures that the initial deferral is made at least 12 months before the forfeiture condition can lapse.

c) Short-term deferrals.

(1) Compensation payable within 2 1/2 months after the close of the year in which it is vested may be deferred (thereby subjecting the compensation to Section 409A) as long as the deferral election is made at least 12 months prior to the vesting date and payment is delayed for a period of at least 5 years from the vesting date. Note, however, the deferral could provide for earlier payment on a change in control without regard to the 5 year rule.

(2) If vesting is accelerated (so that the service provider becomes vested within 12 months of the election), giving effect to the election would
result in an automatic violation of Section 409A.

d) Performance-based compensation.

(1) Election for “performance-based compensation” must be made 6 months prior to the end of the period over which performance is measured—for instance, by June 30th 2006 for the bonus year ending 12/31/06.

(2) “Performance-based compensation” is compensation, the payment or amount of which is contingent on the satisfaction of pre-established organizational or individual performance criteria, and which is not readily ascertainable at the time of the election. It may be based on an increase in the value of the service recipient company, or company stock, after the date the stock right is granted.

(3) First prong: Performance criteria.

(a) Subjective performance criteria are permissible, provided that:

(i) The subjective performance criteria relate to (i) the performance of the executive, (ii) the performance of a group of service providers that includes the executive, or (iii) the performance of a business unit for which the executive provides services; and

(ii) The determination that the subjective performance criteria have been met is not made by the executive, a member of the executive’s family, a person the executive supervises, or a person over whose compensation the executive has any control.

(4) The performance criteria can be established any time within the first 90 days of the performance period, provided that the outcome
is not substantially certain at the time the criteria are established.

(5) **Second prong:** Payment of compensation must be contingent on satisfying the performance criteria.

(a) **Amount** must not be readily ascertainable at the time of the election.

(b) The amount of compensation must not be substantially certain to be paid, regardless of the level of performance.

e) **Fiscal year compensation.**

(1) Deferral elections with respect to compensation based on the service recipient's fiscal year, can be made before the end of the prior fiscal year (e.g., in the case of a fiscal year ending June 30th, a deferral with respect to FY 2008 compensation can be made by June 30, 2007).

(2) The fiscal year rule would apply to bonuses paid on performance during the fiscal year, but would not apply to regular salary or other compensation not determined on a fiscal year basis.

f) **Commissions.**

(1) Commissions are treated as being paid for services performed during the year that the customer makes payment for the goods or services giving rise to the commission. Thus, the service provider could make a deferral election through December 31 with respect to commissions based on customer payments made during the following year.

3. **Non-Elective Deferrals**

a) The timing requirements do not apply to non-elective deferrals (because the service provider does not have a choice whether or not to defer the compensation). However, the time and form of the distribution must be specified by time the service provider has a legally
binding right to the compensation. The service recipient cannot have any ongoing discretion to alter the time or manner of payment. In other words, plans must be "hard wired" (so there is no discretion and you know exactly when and under what circumstances compensation will be paid).

B. **Content of Deferral Elections**

1. A deferral election must specify:
   a) The amount of compensation being deferred.
   b) The timing of when the deferred compensation will ultimately be paid out.
   c) The form in which the deferred compensation will ultimately be paid out.

C. **Irrevocability of Compensation Deferral Election.**

1. General rule: Amount of compensation being deferred must be irrevocable.

2. Exceptions:
   a) Plan can permit changes in filed elections prior to last day it becomes irrevocable (i.e., a deferral election filed before 12/31 can be changed prior to 12/31).
   b) Cancellation of a deferral election mid-year (and for the remainder of the year) is permissible if the participant has received a distribution from the nonqualified plan due to an unforeseeable emergency, or from a 401(k) plan due to hardship.
   c) **Wrap Elections.** Adjustments in nonqualified plan deferral elections that occur automatically, based on the deferral elections made in a qualified 401(k) plan, are permitted and do not violate the rule against irrevocable elections.

(1) The rule regarding irrevocable elections is not violated if amounts deferred increase or decrease depending on an election made in an underlying plan.
(2) Safe harbor designs sanctioned by proposed regulations.

(a) Amount of increase in additional nonqualified deferrals linked to 401(k) plan do not exceed the IRS limit on elective deferrals ($15,000 for 2006); same limit applies to additional matching contributions made under a nonqualified plan.

(b) Spillovers: Nonqualified plan can be designed to provide that as long as the executive specifies a percentage of pay that will be contributed to the nonqualified deferred compensation plan at the end of the year, within a reasonably administrative period of time after the end of the year, an amount is transferred from the nonqualified plan to the underlying 401(k) plan up the IRS limits on elective deferrals ($15,000 for 2006), with the balance remaining in the nonqualified plan. This is not deemed to be an impermissible acceleration of payments.

VI. Distributions of Deferred Compensation

A. Irrevocability of Payment Elections

1. Payment election must be in writing at the time the compensation is initially deferred.

2. Must be irrevocable regarding the time and form of payment.

3. Limitations on subsequent elections or changes in elections:

   a) Cannot take effect for at least 12 months.

   b) Must be made at least 12 months before the first payment is due.

   c) Must defer payments for at least 5 years (or upon death, disability, or unforeseeable emergency).
4. The purpose of the 12 month/5 year rule is to provide flexibility with respect to distributions, but at the same time subject the change to an additional 5 years of "employer credit risk" as the price for the change.

5. The proposed regulations contain special rules designed to permit a change to or from an annuity or installment payment election, or from one type of annuity to another.

a) A change in one type of annuity to another is not treated as a change in the form of payment, as long as the change is made before payments commence. Thus, an election to change from a joint and survivor annuity to a life annuity would not be viewed as a change in the form of payment.

b) For purposes of the rules permitting a change in payment election, an annuity form of payment is treated as a single payment that is made on the annuity starting date. This rule allows a change from an annuity to another form of payment (e.g., lump sum), as long as the change is made at least 12 months prior to the scheduled annuity starting date and the payment is deferred from at least 5 years from the scheduled annuity starting date.

c) Installment payments are also treated as a single payment that is made on the first installment date, unless the arrangement provides that each installment is to be treated as a separate payment.

6. Note that the proposed regulations do not permit a payment election to be linked to a qualified plan election (which is typical for defined benefit SERPs). Instead a separate payment election must be made with respect to the deferred compensation. However, the rules regarding payment elections do provide some flexibility (by providing that a change from one annuity form of payment to another will not be treated as a change in a payment election).

7. Other delays permitted under certain circumstances.

a) Types of delays permitted by proposed regulations:
   
   (1) Where company expects a limitation or elimination of its deduction for the payment because it would be subject to the limitations on compensation payable to executives of
publicly-held companies under IRC Section 162(m).

(2) Where company expects that making the payment would violate a loan covenant or similar contract, resulting in material harm to the company.

(3) Where company expects that payment would violate Federal securities laws or other applicable laws.

b) Generally, delay is only permitted until the 1st calendar year following the expiration of the condition that caused the delay; then distributions must be made.

c) Caution: Plan amendments to add these delay provisions cannot take effect for at least 12 months after adoption.

B. Permitted distribution events

1. Distributions of deferred compensation may not be made, except in connection with one of the following events:

2. Separation from service.

a) The proposed regulations do not adopt the “same desk” rule.

b) In the case of an employee, the proposed regulations generally define a separation from service as a termination of employment. However, if the employee continues providing services in some capacity following termination, the extent to which the termination constitutes a separation from service will be determined based on the facts and circumstances, taking into account the level of services that continue to be provided. The IRS is clearly concerned about situations that would allow employees to delay payment on separation (e.g., through an agreement to be available for consulting services following termination), and situations where an employee "separates" in order to receive a distribution, but continues to provide significant services.
(1) An agreement to provide consulting services following termination will not postpone the separation from service if only insignificant services are performed.

(2) Similarly, if an employee continues to perform significant services, a separation from service will not occur.

(3) Threshold for “significant services”:

(a) In the case of services which continue to be provided as an employee, services will not be considered "insignificant" if (i) the services rendered are equal to at least 20% of the services rendered, based on a rolling three calendar year average, and (ii) annual remuneration for the services is at least 20%, of the average annual compensation during the three calendar year averaging period.

(b) In the case of services which are provided in a non-employee capacity, services will be considered "significant" if (i) the services rendered are equal to 50% or more of the services rendered, based on a rolling three calendar year average, and (ii) annual remuneration for the services is 50% or more of the average annual compensation during the three calendar year averaging period.

c) Temporary leaves of absence will not be considered a separation from service if less than 6 months in duration, or if there is statutory or contractual guarantee of reemployment, such as under USERRA or FMLA.

d) Amounts payable to "specified employees" of a public company on separation from service, cannot be made earlier than death or 6 months following separation.
(1) Public company is defined as any company that has stock which is publicly traded on an established securities market.

(2) A "specified employee" refers to a "key employee" under the top heavy rules, and is any:

   (a) Officer who makes over $135,000 (limited to 50).

   (b) 5% owner.

   (c) 1% owner making over $150,000.

(3) The determination of key employees can be made using any 12 month look back period ending on the "identification date." Any date can be used, but the same identification date must be used for all deferred compensation arrangements, and any change in the identification date cannot be effective for 12 months. If no identification date is identified, the identification date is deemed to be December 31st.

(4) A person who is a key employee on the identification date is treated as a "specified employee" for the 12 month period beginning on the first day of the fourth month following the identification date. For example, if the determination of key employees is made based on a 12 month period ending December 31st, a person who is a key employee on that date would be a "specified employee" for the 12 month period beginning the following April 1st.

(5) The plan or agreement must specify how the delay in payments will be handled. The delayed payments can either be paid in a lump sum after the expiration of the 6 month period, or the agreement could provide that each scheduled payment will be delayed 6 months.

   (a) The manner in which the delayed payments are handled can be changed at anytime, but the change cannot be effective for a period of 12 months.
(unless the amendment is made prior to the date the employer has any publicly traded stock).

(6) The 6 month delay rule does not prohibit payments made pursuant to a domestic relations order or certificate of divesture, or the payment of employment taxes on the delayed payments.

3. Death

4. Disability

a) Defined as inability to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for at least 12 months.

b) Exception made to "any occupation" requirement, if participant is an employee who has been receiving benefits under the employer's LTD plan for at least 3 months.

c) An executive may be deemed disabled if he/she is determined to be disabled by the Social Security Administration, or under the terms of any disability insurance program which incorporates these definitions of disability.

5. Specified date (or according to fixed schedule)

a) The amount of the payment and the payment date must be objectively determinable at the time the amount is deferred (e.g., payment on a fixed date or according to a fixed schedule).

b) The plan or arrangement must "hard wire" the amount and time of payment.

c) The amount of the payment can be fixed or determined pursuant to a nondiscriminatory formula (e.g., the payment amount could be 50% of the account balance).

(1) The requirement that the payment amount must be objectively determined can create
problems for taxable reimbursement, where the amount is not known when the right to payment vests. Although the problem can be solved during the term of employment by tying the payment to continued employment on the payment date, the issue will be payments following termination that are payable after the short-term deferral period.

(2) The problem could also be addressed by providing the executive will be paid a specified dollar amount to cover the reimbursement, regardless of whether the expense is actually incurred. For example, the agreement could provide that the executive will be paid $5,000 to cover tax preparation following termination. However, employers may not be willing to provide such a flat payment in lieu of actual reimbursement for certain benefits (e.g., legal fees).

d) The specific date on which payment is to be made must be specified (or objectively determined).

(1) The proposed regulations allow plans to specify the calendar year in which payment will be made, without specifying a particular date.

(a) If the plan only specifies the year of payment (and does not specify an actual date), the payment date will be deemed to be January 1 for purposes of the rules permitting a subsequent elections to delay payment or change the form of payment.

(2) According to the legislative history, "[a]mounts payable upon the occurrence of a specified event are not treated as amounts payable at a specified time."

(a) The proposed regulations do permit payments to be made on a specified date (or according to a specified schedule) following the occurrence of a vesting event. Thus, for example, the plan that provides for a payment three
years after the date of an IPO would be deemed to have specified a specific date for payment (even though payment is tied to an event).

(i) If payment is made more than 2 1/2 months after the close of the year in which the compensation vests (so that the payment is deferred compensation for purposes of Section 409A), an acceleration of the vesting date cannot accelerate the payment date.

(ii) If, on the other hand, the plan provides for payment within 2 1/2 months after the close of the year in which vesting occurs, the acceleration of vesting (and accelerated payment on vesting) should not violate 409A because the payment is not deferred compensation for purposes of Section 409A (and, as such, is not subject to the anti-acceleration rule discussed later).

(b) Note that the proposed regulations do not specifically permit payment tied according to a schedule tied to other events. This could create significant problems.

(i) An employment agreement provides for payment of any Section 4999 excise tax (and a gross-up on the payment) within 10 days after a final determination that the tax is due. It does not appear that a clause would satisfy the fixed payment date requirement because the payment date is triggered by the occurrence of an event. On the other hand, the agreement could provide that payment of any tax
will be made within a specified number of days after the change in control event triggering the tax has occurred. However, the date specified would have to be far enough in the future to assure that a final determination as to the tax due has been made. As a practical matter, agreements would need to be drafted so that (1) payment is made when the tax is initially due (without regard to any contest), and (2) any contest over the amount or liability for the tax will be in the nature of a refund action.

(ii) Other potential problem areas involve taxable reimbursements.

(iii) Note that payment tied to an event should not be a problem where the event itself is a condition of the payment (so that the right to payment does not vest until the event occurs). In this case, payment within a specified time after the event occurs should satisfy the fixed payment date requirement. Of course the condition (event) has to be related to the purpose of the compensation to constitute a substantial risk of forfeiture.

6. **Change in control.** Deferred compensation can be paid following a change in control (as defined for purposes of Section 409A).

   a) Must relate to company for whom the executive was providing services at the time of the change in control event; the company that is liable for the payment of the deferred compensation; or the company that is a majority shareholder of either of the above.

   b) Change in more than 50% ownership of the total fair market value or total voting power of the stock.
c) Change in effective control:

(1) Any person acquires ownership of stock with at least 35% or more of the total voting power of the stock of the company; or

(2) A majority of members of the company’s board is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the incumbent board.

d) Change in effective control:

(1) Change in ownership of at least 40% of the gross fair market value of assets of the company immediately prior to the acquisition.

e) Transfer to related persons will not cause a change in control event.

f) Note that a plan can use other change in control definition for plan purposes other than distribution, such vesting (that does not otherwise trigger a distribution of deferred compensation subject to Section 409A).

g) While the anti-acceleration provisions generally prohibit the discretion to terminate the plan and payout the deferred compensation, the plan sponsor can reserve the discretion to terminate the plan and payout the deferred compensation within 12 months of a change in control (for purposes of Section 409A).

7. Unforeseeable emergency

a) Defined as severe financial hardship resulting from:

(1) Illness or accident of the service provider, his/her spouse or dependents (for income tax purposes)

(2) Loss of participant's property due to casualty (includes uninsured home damage)

(3) Other extraordinary and unforeseeable circumstances beyond the participant's control.
Examples of other "unforeseeable emergencies include:

(a) Imminent foreclosure or eviction from primary residence.
(b) Medical expenses
(c) Funeral expenses of spouse or dependent.

b) Based on definition of unforeseeable emergency under Section 457 The concept of unforeseeable emergency is not the same as financial hardship under Section 401(k). (Unforeseeable emergency is narrower (more restrictive) than financial hardship.)

c) Distribution must be limited to amount necessary to satisfy need.

d) Distribution can also include amount needed to pay taxes on distribution.

e) Distribution is net of amounts available through reimbursement, insurance or liquidation of other assets (provided liquidation would not cause severe financial hardship).

8. Different payment date schedules can be designated for different payment events. For example, a service provider could elect a lump sum payment on a change in control or death, and installments over 10 years for payments made following separation.

9. Proposed regulations provide some flexibility:

a) A payment will be treated as being made on the specified payment date as long as it is made on that date, or on a later date within the same calendar year (or, if later, by the 15th day of the 3rd month following the date specified under the arrangement).

b) If calculation of the amount of the payment is not administratively practicable due to events beyond the control of the executive; if company does not have sufficient funds to make the payment without jeopardizing the company’s solvency; or if there is a
dispute about the payments or the company’s refusal to make the payments.

c) Generally, in those cases, the proposed regulations provide that the payment will be treated as being made on the payment date specified as long as it is made during the first calendar year in which the funds the situation is resolved.

VII. How does Section 409A limit acceleration events?

A. A nonqualified deferred compensation arrangement subject to Section 409A cannot permit acceleration of the time or schedule of any payment, except as specifically authorized by the IRS in regulations.

1. "Haircut" provisions are not permitted

2. No form of "acceleration" discretion – including employer discretion – is permitted.

   a) This includes "discretion" to terminate plan and accelerate payments (but see discussion below for circumstances under which plan can be terminated).

3. Acceleration permitted for payments required to be made under a domestic relations order.

4. Acceleration permitted for payments necessary to comply with a divestiture for a conflict of interest.

5. Acceleration permitted for de minimis payments of less than $10,000, provided that the executive has no interests in any other similar nonqualified deferred compensation plans and payments are made before the later of (i) December 31st following separation from service, or (ii) 15th day of 3rd month following separation from service.

6. Acceleration permitted to pay FICA and income tax withholding on amounts deferred.

   a) Income tax withholding would apply to 457(f) arrangement (where income is recognized when the compensation vests).

7. Acceleration permitted upon termination of the plan in limited circumstances:
a) Corporate dissolution or bankruptcy.

b) Within 30 days before, or 12 months following a change of control, but only if all similar arrangements are terminated and all amounts deferred are paid out within 12 months of the date of termination.

c) In the company’s discretion, but only if all arrangements are terminated; no other payments are made within 12 months of the termination; all payments are made within 24 months; the company does not adopt a new arrangement any time within 5 years.

8. IRS is considering development of additional circumstances under which plan could be terminated.

9. A intervening distribution event that operates to accelerate payments will not violate the anti-acceleration rule. For example, a service provider elects to receive deferred compensation in installments over 10 years after separation, but elected a lump sum on a change in control. If a change in control occurs after installment payments have commenced, the remaining amount due can be paid in a lump sum without violating Section 409A.

VIII. What limitations are imposed on funding deferred compensation?

A. Section 409A affects the funding of deferred compensation in two respects. First Section 409A effectively eliminates offshore or foreign trusts. Second, it eliminates "springing" rabbi trusts that are based on financial triggers.

B. The deferred compensation "sanctions" are triggered if property set aside to provide deferred compensation is transferred (or located) outside the U.S., even if the assets are subject to the claims of general creditors. This provision was included because of the difficulty creditors might have in reaching assets held abroad, even though the assets are technically subject to the claims of creditors.

C. The deferred compensation "sanctions" are also triggered if a plan provides that assets will be set aside to pay deferred compensation upon a change in the financial health of the employer, even though the assets remain subject to the claims of general creditors. The mere inclusion of a financial health clause triggers the sanctions, even if the financial health provisions are never triggered.
D. Traditional Rabbit trusts are still ok – even Rabbi trusts that spring on a change in control.

E. If an otherwise springing Rabbi trust happens to fund coincidentally at the same time a financial event occurs, that is ok. (e.g., a change in control trigger occurs at the same time a change in finances occurs). However, the otherwise permissible trigger cannot be a disguised change in financial health.

IX. Effective Date and Transitional Rules

A. When did Section 409A take effect?


2. The new rules do not apply to compensation deferred prior to 2005, as long as the arrangement is not "materially modified" after October 3, 2004.

B. Grandfathering of pre-2005 deferred compensation

1. Amounts deferred prior to January 1, 2005 are not subject to Section 409A, unless the deferral is "materially modified" after October 3, 2004.

2. In order for an amount to be considered as having been deferred prior to 1/1/2005, the amount must have been "earned and vested" as of 12/31/2004.
   a) In order to be grandfathered, the service provider had to have a legally binding right to the compensation on 12/31/2004. If the amount was subject to "negative discretion" (i.e., the employer had the discretion to reduce the amount payable), a legally binding right would not exist.
   b) Amounts which were not vested (i.e., subject to a substantial risk of forfeiture or conditioned upon the performance of future services) as of 12/31/2004 do not qualify (and are subject to Section 409A).
      (1) A stock option, SAR other stock right will be considered vested if it was exercisable on 12/31/2004 or was not forfeitable (even if the term of the stock right would expire upon a separation from service). In the case of an option or SAR, exercise would have to result in
a cash payment or the issuance of vested stock. If stock issued upon exercise was subject to a further vesting requirement, the option or SAR would not be considered to be vested as of 12/31/2004.

3. The calculation of the amount "grandfathered" is on the basis of the amount payable as of 12/31/2004 (plus subsequent earnings).
   
a) In the case of an account plan, the amount grandfathered is the account balance as of 12/3/2004, plus future earnings on the 12/31/2004 account.

b) In the case of equity based compensation, the amount grandfathered is the amount payable if the right had been exercised on 12/31/2004, plus future earnings. Future earnings would include any future appreciation in the underlying stock. Thus, if an option was exercisable on 12/31/2004 for 1,000 shares, the 1,000 shares would be grandfathered (regardless of the underlying value of the shares on 12/31/2004).

c) In the case of a non-account plan (such as a defined benefit SERP), the amount grandfathered is the amount to which the service provider would have been entitled if employment had terminated on 12/31/2004 plus the value of any additional amount that becomes payable following 12/31/2004, but which is not related to the performance of additional services. Earnings consist of any increase in the present value of the benefit payable as of 12/31/2004 (determined using the same interest rate used to calculate the grandfathered amount).

   
a) A material modification is defined as a material enhancement of an existing benefit or right, or the additional of a new benefit or right (e.g., a haircut provision is added to the plan).

b) The following actions would not be considered a material modification:
   
   (1) The exercise of employer discretion over the time and manner of payment, provided such
discretion was reserved under the terms of the plan in effect on October 3, 2004

(2) The reduction of a benefit (e.g. removal of a haircut provision).

(3) The establishment of a rabbi trust

(4) A cessation of benefits (accruals).

(5) Changes in investment measures.

c) In addition, a material modification can be rescinded (without resulting in the loss of grandfather treatment), as long as the rescission occurs within the same calendar year as the material modification. For example, a haircut provision is added to a grandfathered plan in 2007. As long as the haircut provision is eliminated by 12/31/2007, the plan will not be considered to have been materially modified.

C. What transitional rules apply?

1. The proposed regulations and Notice 2005-1 provide certain transition rules.

2. Extension of certain deadlines until 12/31/2006

a) Payment elections with respect to amounts payable in 2006. Notice 2005-1 (Q&A 19(c)) permitted service providers to make a new payment election with respect to previously deferred compensation, without regard to the subsequent deferral and anti-acceleration rules. The period for making this election has been extended to 12/31/2006 (but see discussion below for action required by 12/31/2005 for amounts otherwise payable in 2006).

b) Payment elections tied to qualified plans. Notice 2005-1 (Q&A 23) provided that a payment election that is linked to a qualified plan election would comply with Section 409A. The proposed regulations do not incorporate this rule, but transition relief has been provided through 12/31/2006 – so that payment elections that are linked to a qualified plan election will not violate 409A through the end of 2006. However, by 12/31/2006, a payment election that complies with Section 409A must be in place.
c) Substitution of non-discounted options/SARs for discounted options/SARs. Notice 2005-1 (Q&A 18(d)) provides that the substitution of a non-discounted option/SAR for a discounted option/SAR will not be viewed as a material modification (as long as the option/SAR is not exercised prior to replacement). The proposed regulations extend the time for substituting the option/SAR through 12/31/2006. Note: if a discounted stock option is not replaced with a non-discounted stock option during the transition period, the exercise of the discounted option would be subject to Section 409A (meaning that the transfer of stock on exercise of the option prior to a permitted distribution date (such as separation from service) would trigger a 20%+ excise tax).

d) Plan amendments

(1) Existing plans. Employers have until December 31, 2006 to make the necessary amendments to bring deferred compensation arrangements into compliance with Section 409A.

(2) New plans. Plans adopted before 12/31/2006 also have until 12/31/2006 to conform to Section 409A (in form).

(3) While the deadline for plan amendments has been extended to 12/31/2006, the plan must still be operated in good faith compliance with Section 409A effective as of January 1, 2005.

(4) Good faith operational compliance can be based on the statutory language, and:

(a) The provisions of Notice 2005-1 (which remains in effect until final regulations are issued), or

(b) The proposed regulations.

(5) Note that an action to accelerate or extend payments after January 1, 2005 (and prior to the actual plan amendment) is not considered good faith operational compliance (even if done in accordance with the existing terms of the plan). As long as the exercise of the
discretion only affected a particular participant, the operational failure would only affect that participant. For example, a plan provides for installment payments of non-grandfathered deferred compensation. Under the terms of the plan, the participant could elect to accelerate payment by taking a 20% "haircut." The participant elected the haircut and received a reduced lump sum distribution after January 1, 2005. The distribution would not be viewed as good faith operational compliance with respect to that participant (but would not affect other participants). Note that in order to avoid the imposition of a 20%+ excise tax, the participant would need to "opt-out" of Section 409A prior to 12/31/2005 with respect to the impermissible distribution.

3. While the documentary compliance date has been moved back to 12/31/2006, there are a number of transition rules which were not extended and will expire at the end of 2005. **To the extent that an employers desires to use one of these transition rules, action must be taken prior to 12/31/2005!**

a) **Cancellation of participation/deferral elections.** Notice 2005-1 (Q&A 20(a)) permits the cancellation of an existing deferred compensation election, as long as the cancellation is made by 12/31/2005 and the compensation is included in 2005 income (or, if later, the year in which the compensation vests). The cancellation can be made by either the service provider (employee) or service recipient (employer). The period for canceling a deferral was not extended and the cancellation must occur by 12/31/2005. In order to comply with Q&A 20(a), the plan must be amended (and the cancellation/termination election made) by 12/31/2005.

b) **Termination of grandfathered plan.** Notice 2005-1 (Q&A 18(c)) provides that termination and payment of "grandfathered" deferred compensation by 12/31/2005 will not be viewed as a material modification that subjects the plan to Section 409A. The period for terminating the plan and making distributions was not extended beyond 12/31/2005.
c) Substitution of non-discounted options/SARs for discounted options/SARs. While the time for substituting a non-discounted option/SAR for a discounted option/SAR has been extended through 12/31/2006, the extension does not cover employers who want to make a cash payment to employees for the lost discount. If an employer wishes to pay the employee in cash for the lost discount, the substitution/payment would need to be completed by 12/31/2005 (because the option would need to be canceled under the provisions of Notice 2005-1 (Q&A 20(a)), to permit the cash payment).

d) Deferral elections. The date for making deferral elections has not been extended. Thus, deferrals of compensation earned in 2006 must be made by 12/31/2005.

e) Payment elections with respect to amounts payable in 2006. While the period for making new payment elections has been extended to 12/31/2006, a change in the payment election with respect to an amount that was otherwise payable in 2006 must be made by 12/31/2005.

X. Compliance Checklist

A. Inventory and review all plans, agreements or arrangements that could be affected by Section 409A.

In addition to traditional forms of deferred compensation: Inventory and review all employment agreements, and severance plans arrangements to determine the extent they are impacted by Section 409A.

Determine whether there are any discounted stock options, discounted SARs, phantom stock or other forms of equity compensation that could be affected by Section 409A.

B. Determine which arrangements are subject to Section 409A and which arrangements are exempt.

C. Determine which arrangements subject to Section 409A have "grandfathered" benefits.
1. Identify and separately account for grandfathered benefits that the employee wants to exempt from the application of Section 409A.

D. Determine what changes need to be made to arrangements to comply with Section 409A and prepare all necessary amendments by 12/31/06 (including amendments to employment agreements).

E. Make sure all affected plans, agreements or arrangements are in operational good faith compliance through 12/31/06.

F. Provide new payment elections for existing deferrals by 12/31/2006.

G. Determine whether plan or deferral elections should be terminated by 12/31/2005.

H. Determine whether new payment elections need to be made for amounts payable in 2006.

I. Review discounted stock options. If employer is considering payment of lost discount, substitute new options by 12/31/2005.