



IRS Issues Final Regulations on Nonqualified Deferred Compensation

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On April 10, the IRS issued final regulations under Section 409A of the Internal Revenue Code regarding the tax treatment of nonqualified deferred compensation (**T.D. 9321**). The final regulations preserve most of the guidance set forth in proposed regulations issued in 2005 and in subsequent notices, including the requirement to amend plans to bring them into documentary compliance by December 31, 2007. Compliance with the final regulations is required on and after January 1, 2008. In the meantime, plans must continue to be operated in “good-faith” compliance, and employers must be able to substantiate their compliance with the rules in place during the transition period.

In general, Section 409A permits the deferral of income on benefits provided under a nonqualified deferred compensation plan only if the plan imposes certain restrictions on the distribution of benefits and the employee makes a timely election on the form and time of payment. In addition to traditional deferred compensation arrangements, Section 409A applies to employment agreements, bonus programs, equity compensation plans, excess benefit plans, change in control agreements and certain severance arrangements that contain provisions deferring the receipt of compensation.

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be operated in “good-faith” compliance. Although amendments are not required to document operational compliance during the transition period, taxpayers must be able to substantiate compliance in the event of an audit.

Below is a summary of changes to prior law and to the proposed regulations that we believe to have the greatest practical import to the benefit plans and arrangements of our clients.

Written Plan Requirement

The final regulations require the material provisions of all deferred compensation arrangements subject to Section 409A to be set forth in writing no later than December 31, 2007, including the following elements:

- The amount to be paid (or the terms of the payment formula);
- The payment schedule or triggering events;
- The conditions of an initial or subsequent deferral election; and
- For public companies, the six-month delay on the payment of severance benefits to specified individuals.

Companies cannot rely on a savings clause. According to the final regulations, any provision that purports to nullify or amend a provision that fails to satisfy Section 409A will be disregarded.

Stock Rights

Under the proposed regulations, an option or stock appreciation right did not provide for the deferral of compensation if the exercise price could never be less than the fair market value of the underlying stock on the date of grant, the option or right did not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise date, and the underlying stock was “stock of the service recipient.” For this purpose, “stock of the service recipient” was limited to publicly traded stock of the corporation (or any other member of its controlled group, applying a 50% ownership standard with certain exceptions) or, if none, the class of common stock

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having the greatest aggregate value or common stock with substantially similar rights, other than stock with preferred liquidation or dividend rights or stock subject to mandatory repurchase obligations.

Service recipient stock. The final regulations have relaxed the exclusion for stock rights in several ways. In particular, the definition of service recipient stock has been broadened to include almost any class of common stock within the meaning of Section 305 of the Code, including stock subject to certain buy-back rights or preferential liquidation rights, even if another class of stock within the controlled group is publicly traded or has a higher aggregate value outstanding. The issuer of service recipient stock may be the company for which the employee was providing services or any entity that is higher on the chain of ownership, applying a 50% ownership threshold (20%, if there are legitimate business criteria, based on the specific facts and circumstances, such as when a joint venture partner issues stock to an employee of the joint venture whom it expects eventually to hire). Options granted prior to April 10, 2007 can continue in effect under their terms as long as the option was issued on "service recipient stock" under a good faith interpretation of the statute and applicable guidance. (Discounted options, however, must be corrected by the end of 2007.)

Valuation. For purposes of valuing private company stock, the proposed regulations established a presumption of fair market value if the valuation was based on one of the following: (i) an independent appraisal, (ii) a generally applicable repurchase formula or (iii) in the case of illiquid stock of a start-up (other than a company that reasonably anticipated that it would undergo a change in control or an initial public offering within the next 12 months), a valuation report by a qualified individual. The final regulations preserve these safe harbors, but shorten the exception for start-ups to 90 days, in the event of a change in control, or 180 days, in the event of an initial public offering. In addition, the final regulations clarify that an independent appraiser is not necessary for a private company valuation, as long as a reasonable individual, informed about the valuator's knowledge, experience, education and training, would reasonably rely on the valuator's advice. The final regulations also clarify that the same valuation method need not be used for determining fair market value at exercise that the company uses for setting the exercise price, as long as the exercise price cannot be changed retroactively through use of another valuation method.

The final regulations also explicitly permit employers to use an average fair market value of public or private stock as long as the identity of the applicable award recipients, the number of shares and the averaging method are determined prior to the beginning of the averaging period. The regulations generally respect the averaging requirements prescribed under foreign law, as long as the averaging period does not exceed 30 days.

Extension of exercise period. The final regulations provide that the extension of the exercise period of an option or SAR (for example, after the option holder's separation from service) will not be treated as a deferral feature as long as the exercise period, after extension, remains within the original term of the option or right or, if shorter, ten years from the date of grant. If the option or right is underwater, the exercise price may be extended freely. The regulations generally exempt extensions granted before April 10, 2007, even if they exceed the limitations of the final regulations.

Short-Term Deferral

The proposed regulations provided that a payment was not deferred compensation if paid on or prior to March 15 of the calendar year following the year in which the employee obtained a vested right to the payment. The final regulations fine-tune this rule in a number of ways. First, they permit certain payments to be treated as short-term deferrals, even if the payment is delayed past the March 15 deadline, if timely payment would be administratively impracticable owing to unforeseeable circumstances, earlier payment would jeopardize the company's ability to continue as a going concern, or payment would cause the employer to lose its deduction pursuant to Section 162(m) of the Code. Second, if a series of payments is made in part by the March 15 deadline and in part afterwards, the final regulations allow the payments that preceded the deadline to be treated as exempt if the plan designates each payment in the stream as a separate payment and the plan does not specify a payment date or specifies a payment date within the year in which the employee becomes vested in the payment. If an arrangement specifically permits a payment that could occur outside the short-term deferral payment (such as payment over a term of years), however, the payment will be covered by Section 409A even if the payment in fact does or could occur within the short-term deferral period. The regulations reaffirm that a payment that is intended to fit the short-term deferral period but in fact misses the March 15 deadline will still

comply with Section 409A if the plan is in writing and the payment cannot be made in more than one taxable year.

Severance Payments

Section 409A generally prohibits the payment of severance benefits to “specified individuals” (key employees) for a period of six months following the termination date. To blunt the potentially harsh effect of this prohibition, the proposed regulations crafted an exclusion from Section 409A for amounts paid on account of an involuntary separation from service as long as the amounts did not exceed twice the employee’s annual compensation or, if less, twice the compensation limit set forth in Section 401(a)(17) of the Internal Revenue Code (in 2007, \$225,000, subject to adjustment for the cost of living). If a severance benefit exceeds this limit, the final regulations provide that the portion of the payment that falls within the limit will still be excluded and may be paid immediately.

Voluntary terminations. The final regulations recognize that a voluntary termination for good reason may effectively be an involuntary termination where the employer takes actions resulting in a material negative change in the employment relationship and such actions are not taken for the purpose of avoiding the requirements Section 409A. The regulations provide a safe harbor treating severance payments as providing for payment upon an actual involuntary separation from service where a voluntary termination occurs within two years of one of the following events:

- A material diminution in the employee’s base compensation;
- A material diminution in the authority, duties or responsibilities of the employee or the supervisor to whom the employee is required to report;
- A material diminution in the budget over which the employee retains authority;
- A material change in the geographic location at which the employee must perform the services; or
- A material breach of the terms of the applicable employee agreement.

The employee must provide notice of the applicable good reason condition within 90 days of its occurrence, and his employer must be given at least 30 days to remedy the condition.

The final regulations establish a presumption that payment upon a voluntary termination, where the employee would have received a severance benefit covered by Section 409A had his employment terminated involuntarily, is in substitution for the forfeited deferred compensation and therefore should be subject to Section 409A. This presumption is rebuttable upon a showing that the payment would have been made in any event (for example, that the payment amount is materially less than the present value of the forfeited amount or that payment is customarily made to employees who do not forfeit a deferred compensation right).

Definition of specified employee. The proposed regulations provided that a company’s specified employees must be identified by application of the top-heavy rules, with certain modifications, at least four months prior to the separation date. The final regulations allow employers to use an alternative method of identifying employees as long as it is reasonably designed to include all specified employees, employs an objectively determinable standard, precludes employees from electively manipulating its application, and causes no more than 200 specified employees from being identified as of any date. The final regulations also include modifications for the identification of specified employees following a merger or acquisition.

Definition of substantial risk of forfeiture. The final regulations reaffirm that the standard of determining when a payment is no longer “subject to a substantial risk of forfeiture,” and thus may be subject to Section 409A, is stricter than under Section 83. For example, conditioning a severance payment on the execution of a release of claims and withholding agreement on an exact payment amount do not necessarily subject the payments to a substantial risk of forfeiture and thus shield them from taxation under Section 409A.

Ad hoc arrangements. The final regulations confirm that a plan is treated as providing for the deferral of compensation (and thus is subject to Section 409A) only if the employee has a binding right during any year to compensation that is or may be payable to him in a later year. Therefore, *ad hoc* severance payments for voluntary or involuntary termination of employment should be excluded from the requirements of Section 409A as long as the payments are in fact made within the short-term deferral period and cannot, pursuant to their terms, be paid in a later year.

Plan Aggregation

The proposed regulations stated that a Section 409A violation with respect to one plan of a company would cause all plans of the company within the same category to be treated as noncompliant. The proposed regulations enumerated four categories for this purpose (account balance plans, non-account balance plans, separation pay plans, and other plans). The final regulations soften the impact of the aggregation rule by splitting account balance plans into two categories—elective account balance plans and non-elective account plans—and by adding four new categories: split-dollar life insurance arrangements, reimbursement plans, stock rights and foreign plans.

In-Kind and Reimbursement Benefits

The final regulations clarify that certain fringe benefits and reimbursements are not nonqualified deferred compensation, including the following:

- Benefits that are excludable from income (for example, health insurance coverage excludable under Section 105 of the Code (excluding taxable “excess reimbursements” under a self-insured medical plan that is deemed to discriminate in favor of highly compensated employees));
- Taxable reimbursements of medical expenses, if paid within the employee’s period of continuation coverage (COBRA), if the employee elected COBRA and has paid the premiums; and
- Reimbursement for certain expenses provided on voluntary or involuntary separation from service, such as reasonable outplacement and moving expenses (including loss on the sale of a house), if the expense is incurred by the end of the second year following the year of separation from service and is paid no later than the end of the second year after the year in which the separation occurs.

In addition, the regulations clarify that reimbursements and in-kind benefits provided under a plan (e.g., personal use of corporate vehicle or aircraft or membership fees) will meet the requirements of a fixed time and form of payment if the plan prohibits amounts allocated to any year from being carried over to another year (for example, if the plan imposes a multi-year or lifetime cap in lieu of an annual cap), the right to payment cannot be subject to liquidation or

exchange, and payment is made no later than the end of the employee’s taxable year after the year in which the employee incurred the expense.

Other Changes

Stream of payments. The final regulations permit rules regarding timing of distributions and subsequent deferrals to be applied either to an entire schedule of payments or to each specific payment under the schedule—for example, for purposes of subsequent deferrals or applying the short-term deferral exclusion.

Definition of separation from service. The final regulations provide that an employee who remains on the payroll but has discontinued actively working for an employer will be treated as having separated from service if the employer and employee reasonably anticipated that no further services would be performed after a certain date or that the level of services would decrease to less than 20 percent of the average level of services performed over the preceding 36 months. If an individual is on sick leave or other *bona fide* leave of absence, however, his employment will be treated as continuing as long as the leave does not exceed six months or, if longer, the period for which the individual retains a right to reemployment by contract or under applicable law. In addition, the regulations provide that a seller and buyer may agree contractually on whether to treat the employees of the seller who continue to work for the buyer as having experienced a separation from service. All employees must be treated alike for this purpose.

Tax gross-ups. The final regulations clarify that a contractual promise to pay certain tax gross-up payments is deferred compensation subject to Section 409A, but the promise complies with the fixed distribution period requirement of Section 409A if the payments are required to be made by the end of the year following the year in which the related taxes are paid.

Foreign qualified plans. The final regulations preserve most of the exemptions for foreign plans that were included in the proposed regulations, including broad-based plans that provide retirement benefits for a wide range of employees, substantially all of whom are nonresident aliens. The new regulations eliminate some of the restrictions on in-service withdrawals and mandatory distributions that limited the application of this exemption under the proposed regulations.

Split-dollar life insurance. Concurrent with the release of the final regulations, the IRS also issued Notice 2007-34, which addressed the application of Section 409A to certain split-dollar life insurance arrangements. The Notice clarifies that these arrangements may be covered by Section 409A, although arrangements treated as loans are exempt as long as the employer has not agreed to forgive the loan after a period of time.

Further Guidance

The final regulations reserved comment on a number of issues, including the application of Section 409A to partnership arrangements, offshore funding arrangements, the calculation and timing of amounts required to be included in income, and reporting and withholding requirements.

All employers are advised to review their benefit plans and employment agreements to determine what amendments may be needed by the end of the year to bring their nonqualified deferred compensation arrangements into compliance with the final regulations.

Material Available On-Line

The following material is available with the indicated file sizes:

- **Final section 409A regulations, T.D. 9321**, as published in the April 17, 2007 Federal Register. [416K]
- **Notice 2007-34**, application of section 409A to certain split-dollar life insurance arrangements. [27K]
- **Notice 2006-100**, transition guidance regarding 2005 and 2006 reporting and withholding. [95K]
- **Notice 2006-79**, additional transition relief. [61K]

- **Notice 2006-64**, interim guidance regarding payments necessary to meet federal conflict of interest requirements. [47K]
- **Notice 2006-33**, transition guidance regarding section 409A(b). [77K]
- **Notice 2006-4**, transition guidance regarding certain stock rights. [59K]
- **Notice 2005-94**, transition guidance with respect to 2005 reporting and withholding. [49K]
- **Proposed section 409A regulations**, as published in the October 4, 2005 Federal Register. [272K]
- **Notice 2005-1**, initial and transition guidance. [201K]
- **Text of section 409A**, as enacted as part of the American Jobs Creation Act of 2004 (Conference Committee Report, H.Rpt. 108-755, pp. 221-227). [65K]
- **Conference Committee explanation for section 409A** (Conference Committee Report, H.Rpt. 108-755, pp. 706-724). [80K]
- Our **October 2005 Tax Bulletin**, discussing the October 2005 proposed regulations. [219K]

Important Information for Readers

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