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How Does Section 409A Affect My Company? A Self-Diagnostic Guide for Employers

BY ETHAN LIPSIG

One of the most significant U.S. employee benefit developments since the passage of the Employee Retirement Income Security Act (ERISA) in 1974 was the enactment of Internal Revenue Code Section 409A in the fall of 2004.[1] This deceptively simple section revolutionizes nonqualified deferred compensation principally by establishing deadlines by which deferral elections must be made and by regulating distribution practices.

Section 409A applies to a great deal more than traditional nonqualified deferred compensation plans. Its broad ambit reaches individual agreements, stock options, and other benefits (including severance pay) that practitioners traditionally had not considered to be ''deferred compensation.''

Every employer needs to analyze the impact of Section 409A on its U.S.-taxable employees, directors, partners, and independent contractors, and on the employer itself. Few will be unaffected. Most employers need to take proactive steps, some by the end of 2005, to preclude the imposition of significant tax penalties—income taxation in the later of the deferral or vesting year, a 20 percent additional tax penalty, and interest penalties. These amounts are levied not only with respect to the noncompliant arrangement but on all simi-

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[1] Unless otherwise noted, all section references are to the Internal Revenue Code.

lar arrangements in which the individual participates, causing one noncompliant arrangement to taint them all. Although these penalties are imposed on the recipients of deferred compensation, their unanticipated imposition will create significant issues for employers, such as demands for tax gross-ups, and tax reporting and withholding issues.

Section 409A analysis is arcane because of its unexpectedly wide scope and the complex rules that its wide scope made necessary. The Internal Revenue Service has only issued two sets of guidance to date, IRS Notice 2005-1, 2005-2 I.R.B. 274 (Dec. 20, 2004), a long set of Q&As that also provides transition relief, and Proposed Treasury Regulations §§ 1.409A-1 through 1.409A-6, *Federal Register* 57,930 et seq. (Oct. 4, 2005).

An earlier version of this article was published after issuance of IRS Notice 2005-1 but before regulations were proposed. The present version has been revised to reflect the proposed regulations. **Significant changes are asterisked to help readers better understand their impact.** IRS Notice 2005-1 has not been rescinded and continues to be relevant as to certain issues, particularly transition rules.

The first section of this guide helps employers compile a comprehensive list, using the ''Section 409A Plan Census Form'' set forth at the end of this guide, of all programs or arrangements to which Section 409A might apply. Later sections help employers determine the extent to which the programs or arrangements they have listed on the form are exempt from Section 409A or compliant with it.

I. Identify Programs or Arrangements to Which Section 409A May Apply

Section 409A potentially applies to any program or arrangement that promises an employee or other service provider compensation payable in a later tax year unless the compensation was taxable in the tax year in which it was first promised.[2] For example, it can apply to an oral promise that may not even remotely resemble a deferred compensation plan, to a promise made to a single individual, or to a terminal leave of absence with pay or benefits. This guide uses the term ''plan'' to refer to any arrangement or program to which Section 409A may apply. Compensation deferred unilaterally by an employee (or other service provider) without the acquiescence or cooperation of his or her employer (or other service recipient) almost certainly is not subject to Section 409A.[3] A good example of such ''nonplan'' deferred compensation would be overtime hours that an employee does not report when worked, as his or her employer requires.

The core element that makes Section 409A potentially applicable is the creation of a legally enforceable right[4] to receive deferred compensation.[5] Legally enforceable rights can be created by contract or by operation of law. For example, an employee's right to receive payment for December services during a normal pay period that ends in January is a plan to which Section 409A potentially applies (although it qualifies for the ''payroll period'' and ''short-term deferral'' exemptions described later).

It is important to distinguish between legally enforceable rights and preconditions to payment, such as a ''substantial risk of forfeiture.''[6] A legally enforceable right generally is one that could be enforced in a court of law if the preconditions to payment were satisfied. Thus, for example, a scientist's unconditional right to receive a payment from his or her employer if the scientist wins a Nobel Prize is a legally enforceable right whether the scientist has won a Nobel Prize or not. In contrast, a right to receive a payment if the payor elects

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[2] Prop. Treas. Reg. § 1.409A-1(a).

[3] Prop. Treas. Reg. § 1.409A-1(c)(1); IRS Notice 2005-1 Q&A-9. These provisions do not clearly state that nonqualified deferred compensation that is provided other than under a ''plan'' is exempt from I.R.C. § 409A; however, they define ''plan'' in a manner that could be construed as recognizing such an exemption. They define it as ''any agreement, method, or arrangement'' that is ''adopted unilaterally by the service recipient or . . . negotiated among or agreed to by the service recipient and one or more service providers or service provider representatives.'' This would seem to encompass all nonqualified deferred compensation arrangements except those unilaterally adopted by a service provider without the service recipient's tacit agreement. For example, a nonexempt employee who unilaterally fails to report overtime hours until after the end of the year in which the services are performed would have a legal right to payment for those hours in a subsequent year that could be subject to Section 409A (unless the employee were taxable on the overtime in the year in which the services were performed on a constructive receipt theory). However, this right probably does not create a ''plan'' to which Section 409A applies because it was unilaterally created by the service provider.

[4] Prop. Treas. Reg. § 1.409A-1(b)(1); IRS Notice 2005-1 Q&A-4(a). This is an important exemption. It exempts all benefits or payments that truly are discretionary, such as unvested future taxable post-employment benefits. The proposed regulations explain that payments that the service recipient may unilaterally eliminate are not considered legally enforceable unless the elimination power is conditional or lacks substantive significance, or the service provider effectively controls, or is a I.R.C. Section 267(c)(4) family member or spouse of, the person who has the elimination power. Prop. Treas. Reg. § 1.409A-1(b)(1). *IRS Notice 2005-1 Q&A-4(a) had mandated a tougher rule, requiring an elimination power to be ignored if it were unlikely that the service recipient would exercise the power, or only could do so after the occurrence of an unlikely-to-occur event, and it did not have the effective control/family member provision. However, objective plan features (i.e., features other than grants of discretion) that may reduce rights do not make rights unenforceable, such as vesting requirements or other substantial risks of forfeiture or adjustment of amounts on account of investment gains or losses, changes in compensation, or offset features. Prop. Treas. Reg. § 1.409A-1(b)(1); IRS Notice 2005-1 Q&A-4(a).

[5] *If earnings are promised on compensation when it is deferred, the earnings are treated as deferred compensation as of the date the compensation is deferred, but a plan may provide different distribution rules or permit different distribution elections for each. Prop. Treas. Reg. § 1.409A-1(b)(2).

[6] A ''substantial risk of forfeiture'' is a precondition to benefit entitlement that either requires ''the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation,'' but only if ''the possibility of forfeiture is substantial.'' Prop. Treas. Reg. § 1.409A-1(d)(1); IRS Notice 2005-1 Q&A-10(a). Extension of the at-risk period or conditions added after the start of the service period for which the compensation is payable are ignored. *Id.* A requirement to refrain from performing services (e.g., a noncompetition agreement) is not by itself a substantial risk of forfeiture. *Id.* Amounts a service recipient could have received without material reduction cannot thereafter be subjected to a substantial risk of forfeiture (e.g., salary deferrals cannot be subjected to a substantial risk of forfeiture). A stock right subject to Section 409A is not subject to a substantial risk of forfeiture if it (or when it first) can be exercised for cash or property that is substantially vested. Prop. Treas. Reg. § 1.409A-1(d)(2). When the service recipient owns a significant amount of the service recipient's or its parent's stock, the facts and circumstances must be considered in determining whether the possibility of forfeiture is substantial. Prop. Treas. Reg. § 1.409A-1(d)(3); IRS Notice 2005-1 Q&A-10(b).

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to make one normally would not constitute a legally enforceable right.

Section 409A applies to plans benefiting individuals, such as employees, directors, partners, and proprietors, as well as corporations, S corporations, partnerships, I.R.C. Section 269A personal service corporations, or similar noncorporate entities.[7] However, the proposed regulations, as did IRS Notice 2005-1, include a ''plumber'' exemption that exempts from Section 409A payments or other rights extended to a nonemployee/nondirector engaged in a trade or business that provides services to two or more unrelated recipients.[8] Section 409A does not apply to legally binding rights extended to service providers who then are using the accrual method of accounting (which individuals almost never use).[9] Both the proposed regulations and IRS Notice 2005-1 refer to persons or entities potentially subject to Section 409A as ''service providers.''[10] and refer to the persons for whom they work as ''service recipients.''[11] This article uses the same terms.

Thus, to recap, an arrangement or plan potentially is subject to Section 409A if it meets all these requirements:

- It defers compensation beyond the end of the service provider's tax year in which he or she first had a legally enforceable right to the compensation.
- The compensation was not taxable in the tax year in which the legally enforceable right to it accrued.
- The compensation is deferred by the service recipient or with its acquiescence or cooperation.
- The service provider was not an accrual taxpayer when the right to the compensation accrued.
- The service provider does not qualify for the ''plumber'' exception (which is not available to persons providing services as employees or directors).

With these basics in mind, the first step an employer using this guide should take is to list each of its plans that potentially are subject to Section 409A in the ''Plan Name'' column of the Section 409A Plan Census Form set forth at the end of this guide. It may be helpful to review the rest of this guide (which explains how to complete the 409A-Exempt and 409A-Compliant columns) because that will enable the employer to omit plans that are clearly exempted from Section 409A, such as tax-qualified retirement plans.

In many cases, no single individual within an employer will be able to identify all of the employer's plans. Therefore, a representative group of knowledgeable individuals drawn from each of the employer's units probably should complete Section 409A Plan Census Forms and then aggregate them into a single combined version of that form, which would serve as a starting point for the employer's efforts to comply with Section 409A.

II. Determine Which Plans Are Exempt From Section 409A

The following types of plans are exempt from Section 409A. In completing the Section 409A Plan Census Form, designate whether a plan or plan feature is Section 409A-exempt in the ''409A-Exempt?'' column by identifying all applicable exemptions using the numbers set forth in the following list. If only part of a plan is exempt, if it is uncertain that an exemption applies, or if the exemption is only temporary (e.g., exemption II.14.f, *infra*) put ''See note x'' in the ''409A-Exempt?'' column and attach an explanation.

1. Short-Term Deferrals: Section 409A does not apply to amounts paid by the 15th day of the third calendar month following the end of the later of the first taxable year of the service recipient or service provider in which the amounts are no longer (or not initially) subject to a substantial risk of forfeiture (i.e., ''vested'').[12] *IRS Notice 2005-1 suggested that the short-term deferral exemption might have been temporary. The proposed regulations would make it permanent. The short-term deferral exemption does not apply to payments that were to be paid after the exemption's deadline, but are paid earlier; *this is a broader version of the IRS Notice 2005-1 exception for amounts electively deferred by the service provider, since it includes nonelective deferrals as well.[13]

a. An oral plan that pays benefits before the short-term deferral exemption deadline will qualify for it. However, such a plan that pays benefits after that deadline (except for reasons noted in paragraph II.1.b, *infra*) will automatically violate Section 409A.[14] In addition, the special delay provisions described in paragraphs III.D.5. and III.E.1, *infra*, will not be available. For this reason, the preamble to the proposed regulations recommends that an plans that intend to qualify for the short-term deferral exemption be set forth in writing and include a date or year for payment.[15]

b. *A payment that would have qualified for the short-term deferral exemption but for the fact that it was paid too late will qualify for the exemption if (i) it was administratively impracticable to pay the amount by the deadline or doing so would have jeopardized the service recipient's solvency; (ii) the conditions in (i) were unforeseeable when the payment was promised; and (iii) it is paid as soon as reasonably practicable.[16]

c. For example, the short-term deferral exemption would exempt a contractual obligation to pay severance benefits in the form of a lump sum to an executive upon involuntary termination of employment.

d. Some plans that normally qualify for the short-term deferral exemption will not qualify for it as to all participants in all cases. A good example is a three-year, long-term incentive program (LTIP) that requires employment through the payment date, June 1 of year four, which is also the vesting date, but provides for accelerated vesting in the event of death or retirement, but with payment remaining deferred to the normal date; Section 409A generally will apply as to persons who die or retire before the payment year.

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[7] Prop. Treas. Reg. § 1.409A-1(f).

[8] Prop. Treas. Reg. § 1.409A-1(f)(3); IRS Notice 2005-1 Q&A-8

[9] Prop. Treas. Reg. § 1.409A-1(f)(2).

[10] Prop. Treas. Reg. § 1.409A-1(f).

[11] Prop. Treas. Reg. § 1.409A-1(g) defines this term as meaning the entity for whom a service provider provides services, and all of the entity's Section 414(b) and 414(c) controlled group affiliates.

[12] See note 6, *supra*.

[13] Prop. Treas. Reg. § 1.409A-1(b)(4)(i); IRS Notice 2005-1 Q&A-4(c).

[14] Preamble to proposed regulations at II.B., 70 Fed. Reg. 57,932 (Oct. 4, 2005).

[15] Preamble to proposed regulations at II.B., 70 Fed. Reg. 57,932 (Oct. 4, 2005).

[16] Prop. Treas. Reg. § 1.409A-1(b)(4)(ii). ''Unforeseeable events'' do not include actions to be taken by the service provider or someone he or she controls, such as providing necessary information. *Id.*

2. Grandfathered Benefits: Section 409A does not apply to rights that accrued and vested prior to Jan. 1, 2005 (including subsequent earnings), if they have not been materially modified after Oct. 3, 2004.[17]

a. The proposed regulations provide detailed rules for determining how much of a benefit is grandfathered, depending on whether the program is an account balance, nonaccount balance, separation pay, or equity-based plan.

b. A plan can be entirely grandfathered (e.g., because it was frozen before 2005), it can be partially grandfathered, or it can be wholly ungrandfathered.

c. Make sure that any changes that affect grandfathered rights will not inadvertently cause grandfathering to be lost. Some employers may find it helpful to entirely separate grandfathered benefits from nongrandfathered benefits by freezing grandfathered plans and starting new Section 409A-complaint plans

3. Certain Tax-Favored Retirement Arrangements: Section 409A does not apply to any qualified retirement plan, tax-exempt annuity, SEP, SIMPLE, or Section 501(c)(18) trust, any other plan described in Section 219(g)(5), or a governmental excess plan described in Section 415(m). [18]

4. Certain Welfare and Nontaxable Benefits: Section 409A does not apply to bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit (i.e., one that only pays death benefits) plans, Archer Medical Savings Accounts, Section 223 Health Spending Accounts, or other nontaxable health reimbursement arrangements.[19]

a. *Although it would seem that Section 409A ought not apply to any nontaxable benefit because Section 409A should not change the tax-free nature of the payment, it appears that Section 409A *may* apply to nontaxable benefits that otherwise are not Section 409A-exempt. Why else would the proposed regulations only exempt certain nontaxable benefits? [20]

b. *How* Section 409A applies to a non-exempt nontaxable benefit is unclear. Section 409A most likely would not make such benefits taxable; rather noncompliant nontaxable benefits might cause other compliant taxable benefits under plans of the same type to become subject to Section 409A penalties.

5. Payroll Periods That Span Tax Years: Section 409A does not apply to payments made to employees in the normal course during a payroll period that spans tax years, as permitted in Section 3401(b), or to similar payments to other service providers.[21]

6. Certain Nonstatutory Stock Options: Section 409A does not apply to a nonstatutory stock option if (i) it is an option to buy the service recipient's or an affiliate's ''stock,'' as defined below; (ii) its exercise price may never be less than the fair market value[22] of the underlying shares at the grant date; (iii) it does not permit the optionee to elect to defer the time for delivery of stock following exercise (the delivery of unvested stock is not a disqualifying deferral feature); (iv) the transfer or exercise of the option is taxable under Section 83 and Treas. Reg. § 1.83-7; and (v) it does not include additional rights that permit the deferral of compensation.[23] However:

a. Stock repurchase rights may prevent the exemption from applying,[24] as may dividend equivalents unless provided under a separate plan (see paragraph II.16, *infra*) or paid promptly (see paragraph III.E.6, *infra*).

b. *IRS Notice 2005-1 did not provide material guidance as to when the modification of an option (or similar rights) would be treated as the grant of a new option, although practitioners expected that virtually any enhancement except accelerated vesting would have that consequence. The proposed regulations fill this gap. They provide that any ''modification'' of an option is treated as the grant of a new option,[25] including successive modifications.[26] A ''modification'' is any change (including the exercise of grantor discretion under a provision in the option[27]) that reduces the exercise price, adds a new deferral feature, or extends or renews the option.[28] Changes to the underlying stock that increase the value of an option are a modification.[29] An

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[17] See Prop. Treas. Reg. § 1.409A-6, setting forth rules that are substantially similar to those in IRS Notice 2005-1, but with several liberalizations, as described in the preamble to the proposed regulations, 70 Fed. Reg. 57953-54 (Oct. 4, 2005). *See also* IRS Notice 2005-1 Q&A-16(a). IRS Notice 2005-1 Q&A-16(b) explains that rights were accrued and vested before 2005 if a legally enforceable right existed prior to Jan. 1, 2005, that was not subject to substantial risk of forfeiture (other than having to remain employed through the end of the payroll period that included Dec. 31, 2004). Q&A-18(a) states that a grandfathered benefit is materially modified if it is enhanced or if a new benefit or right is added to it (even if the change is itself Section 409A-compliant), whether by amendment or exercise of discretion, other than pursuant to a discretionary power to effect the time or manner of payment that was in the plan as of Oct. 3, 2004. Investment changes generally are not material modifications, nor are reductions in rights. Q&A-18(b) provides that new benefits, whether under the old arrangement or a new one, are presumed to be material modifications, but states that this presumption can be rebutted if the new grant is consistent with the employer's historical practices. Q&A-18(b) further provides that post-Oct. 3, 2004, deferrals will not be treated as material modifications of grandfathered amounts ''if the plan explicitly identifies the additional deferral of compensation and provides that the additional deferral of compensation is subject to Section 409A.'' Q&A-18(c) states that suspension of a plan is not a material modification, nor is termination and a taxable cashout in 2005, which is permitted by the transition rule in Q&A-20. Q&A-18(d) permits nongrandfathered, I.R.C. Section 409A-noncompliant options and stock appreciation rights (SARs) to be replaced in 2005 by I.R.C. Section 409A-compliant awards if the requirements enumerated in that Q&A are satisfied.

[18] Prop. Treas. Reg. § 1.409A-1(a)(2); IRS Notice 2005-1 Q&A-3(b).

[19] Prop. Treas. Reg. § 1.409A-1(a)(5); IRS Notice 2005-1 Q&A-3(c).

[20] *See, e.g.*, Prop. Treas. Reg. § 1.409A-1(a)(5), 1.409A-1(b)(9)(iv).

[21] Prop. Treas. Reg. § 1.409A-1(b)(3); IRS Notice 2005-1 Q&A4-(b).

[22] Prop. Treas. Reg. § 1.409A-1(b)(5)(iv) provides guidance on how fair market value is to be determined.

[23] Prop. Treas. Reg. § 1.409A-1(b)(5)(i)(A), 1.409A-1(b)(5)(i)(D); IRS Notice 2005-1 Q&A4-(d)(iii). Prop. Treas. Reg. § 1.409A-1(b)(5)(i)(C) cautions that the exemption could be lost if the exercise price could be reduced below fair market value as of the grant date. It is not clear whether the option agreement must preclude repricing the option below fair market value, or whether it is only such a repricing that would cause the problem.

[24] Prop. Treas. Reg. § 1.409A-1(b)(5)(iii)(A).

[25] Prop. Treas. Reg. § 1.409A-1(b)(5)(v)(A).

[26] Prop. Treas. Reg. § 1.409A-1(b)(5)(v)(J).

[27] Prop. Treas. Reg. § 1.409A-1(b)(5)(v)(F).

[28] Prop. Treas. Reg. § 1.409A-1(b)(5)(v)(B). However, Prop. Treas. Reg. § 1.409A-1(b)(5)(v)(C) permits two types of extension: (i) an extension to the later of the end of the calendar year in which the option otherwise expires or the 15th day of the third calendar month following that expiration date, or (ii) an extension for 30 days after the exercise would no longer violate securities laws.

[29] Prop. Treas. Reg. § 1.409A-1(b)(5)(v)(G).

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increase in the number of shares that may be exercised under an option is treated as a new separate grant, not a modification.[30] However, the proposed regulations imply that the ''modification'' definition is broader than it may actually be by stating that it is not a modification (i) to make certain adjustments to the number of shares or exercise price under an option to reflect stock splits or stock dividends,[31] (ii) to add a provision permitting previously acquired stock to be used to pay the exercise price or cashless tax withholding, (iii) for the grantor to permit an option to be transferred if it includes a provision giving the grantor that discretion,[32] (iv) to accelerate vesting,[33] and the preamble to the proposed regulations also states that it would not be a modification to add a transfer provision to an option or to permit cashless exercise.[34] Inadvertent modifications can be rescinded without causing any adverse Section 409A consequences if rescinded before the earlier of exercise or the end of the calendar year in which the modification occurred.[35] Option substitution in connection with corporate transactions would not be treated as the grant of a new option if certain requirements are met.[36]

c. *Except with respect to stock rights granted before Dec. 31, 2004,[37] ''stock'' means common stock that is readily traded on an established securities market or, if none, common stock of the class whose outstanding shares have the greatest value (or substantially similar common stock (disregarding voting rights)). Stock with preferred liquidation or dividend rights is not ''stock,'' nor are shares that are subject to mandatory repurchase or certain put or call rights.[38] ''Stock'' ADRs are treated as ''stock,''[39] as are certain mutual insurance company equity units. [40]

d. The stock option exemption does not apply to options to buy the stock of an unrelated entity (a plan design heavily promoted, often with in-the-money options, particularly to tax-exempt entities). Unless such options are grandfathered, they normally would have to be modified to comply with Section 409A. *The stock option exemption also does not apply to stock in a corporation the primary purpose of which is to serve as an investment vehicle in entities other than the service recipient and its affiliates, except as to service providers directly providing services to it.[41]

e. *Affiliates of the service recipient are determined under I.R.C. Sections 414(b) and (c) rules. These rules may be applied using a 50% standard in lieu of the 80% standards that normally apply or, if there is a legitimate business reason, a 20% standard (e.g., as to employees transferred to a joint venture by a 20% or greater joint venturer, its stock will qualify as service recipient affiliate stock). A service recipient must designate a below 80% standard, apply it consistently, and not make any change in the standard effective before 12 months have elapsed since the change.[42]

f. *The proposed regulations provide considerable guidance, including a special rule for start-ups,[43] that should quell much of the uncertainty as to what constitutes a reasonable method for determining the fair market value of nonpublicly traded stock, but many issuers in the past used methods that might not meet the proposed regulations' standards. If so, as to options that are not grandfathered and that might have been issued at below market strike prices or repriced below fair market value at the date of grant, the prudent course of action would be to make them Section 409A-compliant or replace them with Section 409A-compliant options. This needs to be done by the end of 2006, but greater transition relief exists if this is done by the end of 2005.[44]

7. Incentive Stock Options (ISOs) and Section 423 Employee Stock Purchase Plans (ESPP) Options: Section 409A does not apply to ISOs or ESPP options, including discounted ESPP options.[45] This exemption does not extend to nonqualified employee stock purchase plans that provide discounted options.

8. Certain SARs: Section 409A generally applies to a SAR unless (i) the SAR only provides appreciation as of the date of exercise in excess of the fair market value[46] of a *fixed number of shares of the service recipient's or affiliate's stock at the time of grant; and (ii) the only deferral feature in the SAR is its exercise provision. *See paragraphs II.6. c.-e, *supra*, for the ''stock'' and ''affiliate'' requirements that a SAR must meet to be exempt. *The proposed regulations eliminated the IRS Notice 2005-1 requirements that the underlying stock be traded on an established securities market and that the SAR be settled in that stock.[47] Unless provided under a separate plan (see paragraph II.18, *infra*) or paid promptly (see paragraph III.E.6, *infra*), dividend equivalents may cause an SAR to fail to qualify for this exemption.

9. Certain SARs Granted Under Pre-Oct. 3, 2004, Plans: Section 409A does not apply to SARs granted under pre-Oct. 3, 2004, plans if certain requirements are met.[48]

10. Certain Restricted Property: Section 409A does not apply to property that is immediately delivered,

[30] Prop. Treas. Reg. § 1.409A-1(b)(5)(v)(H).
[31] Prop. Treas. Reg. § 1.409A-1(b)(5)(v)(H).
[32] Prop. Treas. Reg. § 1.409A-1(b)(5)(v)(B).
[33] Prop. Treas. Reg. § 1.409A-1(b)(5)(v)(E).
[34] *See* 70 Fed. Reg. 55,935-36 (Oct. 4, 2005).
[35] Prop. Treas. Reg. § 1.409A-1(b)(5)(v)(I).
[36] Prop. Treas. Reg. § 1.409A-1(b)(5)(iii)(D)(3).
[37] Prop. Treas. Reg. § 1.409A-1(b)(5)(iii)(E).
[38] Prop. Treas. Reg. § 1.409A-1(b)(5)(iii)(A).
[39] Prop. Treas. Reg. § 1.409A-1(b)(5)(iii)(B).
[40] Prop. Treas. Reg. § 1.409A-1(b)(5)(iii)(C).
[41] Prop. Treas. Reg. § 1.409A-1(b)(5)(iii)(D)(2).
[42] Prop. Treas. Reg. § 1.409A-1(b)(5)(iii)(D)(1).
[43] Prop. Treas. Reg. § 1.409A-1(b)(5)(iv).
[44] Preamble to proposed regulations at XI.H., 70 Fed. Reg. 57,956 (Oct. 4, 2005).
[45] Prop. Treas. Reg. § 1.409A-1(b)(5)(ii); IRS Notice 2005-1 Q&A-4(d)(iii). But note the problematic circularity of this exemption as to nonpublicly traded issuers that may have underestimated the fair market value of their stock: if ISOs are issued with a below market strike price or if ESPP options are issued with too low a strike price, they would not be Section 409A exempt under the ISO/ESPP exemption or under the exemption for certain nonstatutory stock options. Prop. Treas. Reg. § 1.409A-1(a)(5)(ii) also cautions that this exemption will not apply to an otherwise exempt option if it is modified, the modification is treated as the grant of a new option, and the new option is a nonstatutory option.
[46] Prop. Treas. Reg. § 1.409A-1(b)(5)(iv) provides guidance on how fair market value is to be determined
[47] Prop. Treas. Reg. § 1.409A-1(b)(5)(i)(B), 1.409A-1(b)(5)(i)(D); IRS Notice 2005-1 Q&A-4(d)(iv). Prop. Treas. Reg. § 1.409A-1(b)(5)(i)(C) cautions that the exemption could be lost if the amount payable could exceed the amount permitted under the exemption.
[48] IRS Notice 2005-1 Q&A-(d)(iv).

whether or not vested at delivery.[49] Although immediately delivered restricted property, such as stock, is exempt from Section 409A, awards in the form of deferred-delivery restricted property, such as stock (usually referred to as restricted stock units or RSUs), are subject to Section 409A unless the property will be delivered within the short-term deferral rule's time limits (see paragraph II.1, *supra*).[50]

11. Certain Section 457(b) Plans: Section 409A does not apply to tax-favored Section 457 plans, except plans that fail to meet Section 457's requirements (i.e., Section 457(f) plans), that are grandfathered under transition rules, or to the extent they provide nonelective deferred compensation to persons who are not employees.[51] However, length of service awards to volunteers under Section 457(e)(11)(A)(ii) are exempt from Section 409A.[52]

12. Issuance of Partnership Interests in Connection With the Performance of Services: Section 409A does not apply to the issuance of capital or profits partnership interests (including through an option) to the same extent that it does not apply to the issuance of stock.[53]

13. Certain Partnership Distributions: Distributions to partners, including distributions that buy a partner out, currently are exempt from Section 409A, except for (i) Section 1402(a)(10) retirement payments to a partner, and (ii) payments to a partner not acting in his or her partner capacity.[54]

14. *Certain Separation Pay[55]: Although Section 409A generally applies to deferred compensation payable on account of separation from service,[56] the following types of separation pay plan or window (i.e., exit incentive) plan[57] benefits are exempt unless they are provided as a substitute for other Section 409A deferred compensation:[58]

a. Collectively-bargained severance pay plan or window plan benefits provided to bargaining unit employees.[59]

b. Noncollectively bargained severance pay or window plan benefits that (i) do not pay (ignoring amounts described in paragraph II.14.c, *infra*) more than the lesser of two times annual compensation (as defined in the proposed regulations) for the calendar year ending before separation or, if less, two times the qualified retirement plan maximum compensation limit under I.R.C. Section 401(a)(17) (currently $210,000), and (ii) are completely paid by the end of the second calendar year following the separation year.[60]

c. Expense reimbursements made, or in-kind benefits provided, before the end of the second calendar year following the separation year if they (assuming they were provided by expense reimbursement to the extent provided in kind) (i) are excludible from gross income, (ii) reimburse business or medical expenses that the service provider could deduct under I.R.C. Sections 162, 167, or 213 (disregarding AGI-based limits); or (iii) are for reasonable outplacement or moving expenses the service provider actually incurs because of his or her termination.[61]

d. Separation pay and benefits that do not exceed $5,000 in the aggregate are exempt from Section 409A.[62]

e. Separation pay and benefits that qualify for other Section 409A exemptions. Separation pay plans that do not have good reason quit provisions and only pay lump sums promptly following termination of employment generally would be exempt under the short-term deferral rule. Separation pay plans that have good reason quit provisions normally would not be exempt from Section 409A. Separation pay plans that pay only fixed installments typically would be Section 409A-compliant. Most separation pay plans permit the sponsoring employer to terminate them (collectively bargained plans, golden and tin parachutes, and executive severance benefit arrangements are the usual exceptions). That termination discretion may be sufficient to preclude severance plans from being considered legally enforceable, thereby potentially exempting them from Section 409A, at least until an employee is terminated and thereby gains a legally enforceable right to payment.

f. IRS Notice 2005-1 exempted benefits paid in 2005 under severance plans that either are collectively bargained or that do not cover any Section 416(i) key employees.[63]

15. *Certain Expense Reimbursements: Taxable and nontaxable expense reimbursements apparently are only exempt from Section 409A *to the extent they are exempt under another exemption*, such as under the short-term deferral rule or the special rule for post-separation reimbursements discussed in paragraph II.14.c. There is some indication that the Internal Revenue Service may reconsider this issue.

16. *Dividend Equivalent Plans: Section 409A does not apply to a ''separate'' dividend equivalent plan that does not otherwise defer compensation, nor does such a separate plan cause otherwise Section 409A-exempt options or SARs to cease to be exempt.[64]

17. *Certain Foreign Plans/Foreign Compensation: Section 409A does not apply to:

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[49] Prop. Treas. Reg. § 1.409A-1(b)(6)(i); IRS Notice 2005-1 Q&A-4(e).

[50] Prop. Treas. Reg. § 1.409A-1(b)(6)(ii).

[51] Prop. Treas. Reg. § 1.409A-1(a)(2)(vii), 1.409A-1(a)(4)); IRS Notice 2005-1 Q&A-6.

[52] Prop. Treas. Reg. § 1.409A-1(a)(2)(vii), 1.409A-1(a)(4)). IRS Notice 2005-1 Q&A-6 had stated that this exemption only would be available ''pending additional guidance.''

[53] IRS Notice 2005-1 Q&A-7. The proposed regulations reserve all partnership issues for future guidance. *See* Prop. Treas. Reg. § 1.409A-1(b)(7). Section II.E. of the preamble to the proposed regulations states that taxpayers may continue to rely on IRS Notice 2005-1 Q&A-7, pending the issuance of further guidance. *See* 70 Fed. Reg. 57,937 (Oct. 4, 2005).

[54] IRS Notice Q&A-7. Distributions to partners, including distributions that buy a partner out, currently are exempt from § 409A, except for § 1402(a)(10) retirement payments to a partner and payments to a partner not acting in his or her partner capacity. See preceding note.

[55] Prop. Treas. Reg. § 1.409A-1(m) defines ''separation pay arrangement.''

[56] Prop. Treas. Reg. § 1.409A-1(b)(9)(i); *see also* Prop. Treas. Reg. § 1.409A-1(h) (defining ''separation from service'').

[57] Prop. Treas. Reg. § 1.409A-1(b)(9)(v) (establishing a one-year limit on window periods and cautioning that excessively repeated offerings may not be regarded as window plans.

[58] Prop. Treas. Reg. § 1.409A-1(b)(9)(i).

[59] Prop. Treas. Reg. § 1.409A-1(b)(9)(ii) (imposing the usual sorts of requirements designed to make sure that the bargaining agreement is bona fide).

[60] Prop. Treas. Reg. § 1.409A-1(b)(9)(iii).

[61] Prop. Treas. Reg. § 1.409A-1(b)(9)(iv)(A)-(B).

[62] Prop. Treas. Reg. § 1.409A-1(b)(9)(iv)(C).

[63] IRS Notice 2005-1 Q&A-19(d).

[64] Prop. Treas. Reg. § 1.409A-1(b)(5)(i)(E).

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a. Any arrangement to the extent (i) contributions to it are not subject to U.S. income tax pursuant to a bilateral tax treaty with the U.S.;[65] or (ii) compensation deferred under the arrangement[66] that would have been exempt from U.S. taxation if it had been paid on the later of the date the deferred compensation was earned or vested (a) pursuant to such a treaty;[67] (b) under I.R.C. Section 872 because the service provider was a nonresident alien;[68] (c) under I.R.C. Section 911(b)(2)(D), taking into account other amounts actually paid (excluding up to $80,000 a year for U.S. citizens or residents working outside the United States);[69] (d) under I.R.C. Section 893;[70] (v) under I.R.C. Section 931;[71] or (vi) under I.R.C. Section 933.[72]

b. A broad-based foreign retirement plan maintained by an non-U.S. person, but only as to (i) a person who for the tax year is a nonresident alien or a I.R.C. Section 7701(b)(1)(A)(ii) resident alien,[73] and (ii) a U.S. citizen or I.R.C. Section 7701(b)(1)(A)(i) resident alien who is not eligible to participate in a tax-favored retirement plan (listed in paragraph II.3 or II.11 above) for the tax year, but only with respect to nonelective deferrals of I.R.C. Section 911(b)(1) foreign earned income, and only if the I.R.C. Section 415 limits, applied based on that foreign earned income, are not exceeded. [74]

c. Foreign social security systems to the extent benefits or contributions are subject to a Social Security Act Section 233 agreement or are government-mandated.[75]

d. Deferrals under a non-U.S. person's foreign plan as to a nonresident alien to the extent they do not exceed $10,000 per taxable year with respect to services performed in the United States.[76]

e. Other foreign arrangements designated by the IRS in the future.[77]

18. *Tax Equalization Agreements: Section 409A does not apply to grossed-up-for-tax payments that reimburse service providers for foreign taxes that cause them to pay more total taxes than if they were only taxed in the United States, but only if no greater payments are made and the payments are made no later than the end of the second calendar year beginning after the calendar year in which the service recipient's tax return is due for the year to which the tax equalization payment relates.[78]

III. Determine Whether Nonexempt Plans Are Section 409A-Noncompliant

To the extent a plan listed in the Section 409A Plan Census Form is not clearly exempt from Section 409A, identify each possible area of Section 409A noncompliance in the ''409A-Noncompliant?'' column of that form by inserting the letters used below to refer to the applicable noncompliance areas. If only part of a plan is Section 409A-noncompliant or if compliance is unclear, put ''See note x'' in the ''409A-Noncompliant?'' column and attach an explanation.

In determining whether a plan is wholly compliant, remember that all plans of a given type in which a participant participates-account balance, nonaccount balance, *separation pay, and equity-based-generally are aggregated and treated as a single plan.[79] As a result, even if a specific plan or plan feature is compliant, noncompliant features in the same plan or any other plan of the same type could cause an otherwise Section 409A-compliant plan or plan feature to be noncompliant.

A. *Unwritten Plans: Although Section 409A does not require plans to be set forth in writing, the proposed regulations impose that requirement, effective Dec. 31, 2006, for plans adopted on or before that date. The plan's terms must satisfy Section 409A, as the plan also must do in operation. The plan must set forth all material terms, including how much is to be paid and how and when it is to be paid. A grace period permits a plan to be set forth in writing by the end of the calendar year in which a legally binding right under it is created (or by the 15th day of the third month of the following year if no payments are to be made that year). Unwritten plans are not aggregated with other plans of the same type for purposes of determining whether the written plan requirement has been satisfied.[80]

B. Untimely Deferral Elections: Section 409A(a)(4)(B)(i) requires deferral elections (by the service provider, *not the service recipient[81]) to be made,

[65] Prop. Treas. Reg. § 1.409A-1(a)(3)(i).

[66] Earnings on such amounts also are Section 409A-exempt except to the extent recharacterized as deferrals under Treas. Reg. § 31.3121(v)(2)-1(d)(2)(iii)(B) (for nonaccount plans), § 31.3121(v)(2)-1(d)(2)(iii)(A) (for account plans), or under similar principles (for other types of plans).

[67] Prop. Treas. Reg. § 1.409A-1(b)(8)(i).

[68] Prop. Treas. Reg. § 1.409A-1(b)(8)(ii)(A). Prop. Treas. Reg. § 1.409A-1(j) defines ''nonresident alien.''

[69] Prop. Treas. Reg. § 1.409A-1(b)(8)(ii)(B).

[70] Prop. Treas. Reg. § 1.409A-1(b)(8)(ii)(C).

[71] Prop. Treas. Reg. § 1.409A-1(b)(8)(ii)(D).

[72] Prop. Treas. Reg. § 1.409A-1(b)(8)(ii)(D).

[73] Prop. Treas. Reg. § 1.409A-1(a)(3)(ii). Prop. Treas. Reg. § 1.409A-1(a)(3)(v) defines ''broad-based retirement plan'' much as one would expect, e.g., written, nondiscriminatory, etc.

[74] Prop. Treas. Reg. § 1.409A-1(a)(3)(iii).

[75] Prop. Treas. Reg. § 1.409A-1(a)(3)(iv).

[76] Prop. Treas. Reg. § 1.409A-1(a)(3)(vi).

[77] Prop. Treas. Reg. § 1.409A-1(b)(8)(iv). Earnings on such amounts also are Section 409A-exempt except to the extent recharacterized as deferrals under Treas. Reg. § 31.3121(v)(2)-1(d)(2)(iii)(B) (for nonaccount plans), § 31.3121(v)(2)-1(d)(2)(iii)(A) (for account plans), or under similar principles (for other types of plans).

[78] Prop. Treas. Reg. § 1.409A-1(b)(8)(iii). Earnings on such amounts also are Section 409A exempt-except to the extent recharacterized as deferrals under Treas. Reg. § 31.3121(v)(2)-1(d)(2)(iii)(B) (for nonaccount plans), § 31.3121(v)(2)-1(d)(2)(iii)(A) (for account plans), or under similar principles (for other types of plans).

[79] Prop. Treas. Reg. § 1.409A-1(c)(2) (also generally providing for disaggregation based on dual employee/independent contractor participation). Prop. Treas. Reg. § 1.409A-1(m) defines ″separation pay arrangement″ as any program that provides compensation ''where one of the conditions to the right to the payment is a separation from service, whether voluntary or involuntary.'' This would seeming convert many account and nonaccount plans into separation pay arrangements, which likely was unintended; the preamble to the proposed regulations, at II.G.2., 70 Fed. Reg. 57940 (Oct. 4, 2005) describes ''separation pay arrangements'' much more narrowly, limiting them to plans that only pay after involuntary termination. *See also* IRS Notice 2005-1 Q&A-9 (not recognizing separation pay plans as a separate type of plan or providing for disaggregation based on dual employee/independent contractor participation).

[80] Prop. Treas. Reg. § 1.409A-1(c)(3).

[81] Prop. Treas. Reg. § 1.409A-2(a)(1); preamble to proposed regulations at V.B., 70 Fed. Reg. 57,943 *(Oct. 4, 2005) stating that ''[t]he requirement that the election be made before the services are performed is not applicable where the participant is not provided any election with respect to the amount deferred, or the time

and to become irrevocable, before the start of the *service provider's tax year[82] in which the services for which the deferred amount is earned are performed,[83] or if the plan so provides as to ''fiscal year compensation,'' before the beginning of the fiscal year or years in which such compensation is earned.[84] Initial distribution form and timing elections by service providers also are subject to this rule.[85] Later deferral or distribution form and timing elections are impermissible, except as follows:

1. Elections When First Eligible: Section 409A(a)(4)(B)(ii) permits elections to be made within 30 days after a service provider first becomes eligible to defer amounts under the plan, but only with respect to services to be performed after the election. Because all plans of a particular type in which an individual participates—account balance, nonaccount balance, separation pay, and equity based—are aggregated as to the participant, until the proposed regulations were issued, it was unclear how liberally this exemption would be interpreted. For example, would participation in another equity-based plan preclude initial elections as to a new equity award? *The proposed regulations unequivocably answer this question ''yes,'' by providing that initial eligibility is determined after applying the plan aggregation rules.[86]

2. Elections as to Performance-Based Compensation: These can be made at any time more than six months before the end of the performance period *if done before ''such compensation has become both substantially certain to be paid and readily ascertainable.''[87] IRS Notice 2005-1 Q&A-22 provided a temporary definition of performance-based compensation for bonus programs that was to apply until more restrictive guidance is issued. *The proposed regulations include a much more comprehensive definition that is generally similar to the Section 162(m) ($1 million deductible compensation limit) definition of performance-based compensation, but with some significant differences.[88]

3. *Elections as to Forfeitable Compensation: An award to be paid in the future that will not vest unless the service provider continues to provide services may be deferred within 30 days after the award becomes a legally binding right as long as the award will not vest for at least 12 months thereafter.[89] This rule likely will result in many one-year vesting schedules being stretched to 13 months, so as to give awardees a 30 day election period.

4. *Elections Linked to Qualified Plans: None of the following will result in an untimely election even though it increases or decreases Section 409A deferred compensation: (i) a ''excess'' version of a qualified employer plan's benefit formula (i.e., one unconstrained by one of more tax code limits on qualified plan benefits); (ii) offsetting qualified plan benefits;[90] (iii) the service provider's determination of whether to receive a subsidized or ancillary qualified plan benefit;[91] (iv) a qualified plan amendment eliminating a subsidized or ancillary benefit or freezing or limiting accruals;[92] (v) the service provider's 401(k) and similar qualified plan deferral elections that do not cause nonqualified deferrals under all Section 409A plans to increase for the calendar year by more than the Section 402(g) 401(k) deferral dollar limit;[93] and (vi) the service provider's 401(k) or after-tax qualified plan deferral elections that affect the level of nonqualified plan matching or similar contributions if (a) those contributions are not made or are forfeited if the qualified plan contributions are not made, and (b) the level of qualified plan 401(k) or after-tax contributions does not increase nonqualified deferrals under all Section 409A plans for the calendar year by more than the Section 402(g) 401(k) deferral dollar limit. Each of these rules only applies if the form or timing of nonqualified plan payments is not affected. [94]

5. *Election as to Compensation Not Subject to Section 409A Under the Short-Term Deferral Rule: Compensation that is to be paid shortly after it vests is not subject to Section 409A. See paragraph II.1, *supra*. The proposed regulations permit such amounts to be deferred if the election meets the ''second election'' requirements in paragraph III.D, *infra* (other than the five-year additional deferral requirement as to amounts payable on account of a change of control event).[95]

6. *Separation Pay Arrangement Elections: An initial election will be timely if made (a) before a bona fide individually negotiated severance package gives the service provider legally enforceable rights to the payment, and (b) as to window plan benefits, before the service provider's election to resign becomes irrevocable.[96] This provision theoretically would permit such initial elections whenever severance contracts are negotiated, although it appears that the IRS meant for this provision to apply only if the negotiations take place in connection with the employee's termination, and did not mean for it to apply to negotiated substitutes for Section 409A-covered deferred compensation.

7. *Elections as to Commissions: To be timely, an election to defer commissions must be made before the service recipient tax year in which the commission is earned. The proposed regulations treat commissions as earned by the service provider in the year in which the

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and form of the payment . . . [but] '[t]he time and form of distribution must be specified at the time of the initial deferral.'' Prop. Treas. Reg. Section 1.409A-2(a)(12) imposes such a requirement. *See also* General Explanation of Tax Legislation Enacted in the 1108th Congress (Blue Book) 472 (May 2005) (stating that amounts ''may be deferred *at the participant's election* only if the election [complies with § 409A's election timing rules]'' (emphasis added)).

[82] Prop. Treas. Reg. § 1.409A-2(a)(2).

[83] Prop. Treas. Reg. § 1.409A-2(a). *See* Prop. Treas. Reg. § 1.409A-2(b)(6) Example 1 (example of initial deferral election as to salary), 1.409A-2(b)(6) Example 3 (example of initial deferral election as to calendar year bonus).

[84] ''Fiscal year compensation'' is compensation earned over a period coextensive with one or more of a service recipient's noncalendar fiscal year, e.g., a bonus earned on a fiscal year basis. *See* Prop. Treas. Reg. § 1.409A-2(a)(5), 1.409A-2(b)(6) Example 4.

[85] Prop. Treas. Reg. § 1.409A-2(a)(1); Blue Book at 473. *See* Prop. Treas. Reg. § 1.409A-2(b)(6) Example 2.

[86] Prop. Treas. Reg. § 1.409A-2(a)(6).

[87] Prop. Treas. Reg. § 1.409A-2(a)(7).

[88] Prop. Treas. Reg. § 1.409A-1(e).

[89] Prop. Treas. Reg. § 1.409A-2(a)(4), 1.409A-2(b)(6) Example 5.

[90] *See* Prop. Treas. Reg. § 1.409A-2(b)(6) Example 13.

[91] *See* Prop. Treas. Reg. § 1.409A-2(b)(6) Example 13.

[92] *See* Prop. Treas. Reg. § 1.409A-2(b)(6) Example 13.

[93] *See* Prop. Treas. Reg. § 1.409A-2(b)(6) Example 12.

[94] Prop. Treas. Reg. § 1.409A-2(a)(8).

[95] Prop. Treas. Reg. § 1.409A-2(a)(3), 1.409A-2(b)(6) Example 6. Such amounts also could be deferred by means of normal, timely Section 409A-compliant initial deferral elections.

[96] Prop. Treas. Reg. § 1.409A-2(a)(9), 1.409A-2(b)(6) Example 9 (negotiated severance), 1.409A-2(b)(6) Example 10 (window benefits).

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customer makes the payment to the service recipient that generates the commission. [97]

8. *Elections as to Pay for Payroll Periods that Straddle Service Provider Taxable Years: IRS Notice 2005-1 did not deal with the issue of deferral elections for a pay period that straddles two of a service provider's taxable years. For example, if a calendar year service provider receives a paycheck in early January for a payroll period that began in December, is his or her election in the prior year untimely if it relates to December pay paid in January? Prop. Treas. Reg. § 1.409A-2(a)(11) generally treats such straddling compensation as compensation earned in the year when it is paid, unless the plan provides otherwise (by Dec. 31, 2006, in the case of plans in effect before that date).[98]

9. *Nonelective Deferrals: The initial election timing rule does not apply to a deferred amount unless the service provider has the right to elect the time or form of payments, but the time and form of payment must be specified no later than when the service provider first has a legally binding right to the deferred amount. Such a designation is treated as an initial deferral election.[99]

10. *Nonresident Aliens Who Become Resident Aliens: For the calendar year in which this occurs, the individual may make a deferred compensation election as to compensation earned during the year or that was unvested at the start of the year, but only as to amounts that were not paid or payable before the election.[100]

11. Elections Made By March 15, 2005, Under Plans in Existence On Dec. 31, 2004: This special transition rule applied if certain easy-to-meet requirements were satisfied.[101]

12. Permissible ''Second'' Distribution Form or Timing Elections: See paragraph III.D, *infra*.

13. Deferral Election Cancellation in 2005: Pre-2006 deferral elections may be cancelled in whole or in part by the service provider or recipient pursuant to a plan amendment (that need not apply to participants generally) permitting cancellation that is adopted before the end of 2005, but only if the cancelled deferrals are taxable in 2005 or, if later, when they first vest.[102]

C. Improper Acceleration of Payments: Payment acceleration is prohibited except as discussed in paragraph III.C.4 below.[103]

1. Even the contingent acceleration of benefits in accordance with plan terms may be improper at least in certain cases. For example, accelerating remaining severance payments and paying them in a lump sum when the service provider commences new employment would be improper acceleration even if provided for in the severance plan from inception because distributions can only be paid pursuant to a fixed schedule or in connection with an allowable distribution event. See paragraphs III.E and III.F, *infra*.

2. Leaving the timing of distributions entirely to the discretion of the service recipient (except to the extent otherwise permitted under the proposed regulations) would violate the acceleration or other Section 409A prohibitions.[104]

3. Another issue is whether *delays* will be subject to the prohibition on accelerations. This may seem counterintuitive, but there is no material difference between (i) providing for a fixed and relatively earlier distribution date or schedule (e.g., a lump sum on termination of employment) and giving the service recipient the right to defer payments (e.g., to commence benefits as late as age 80 in the form of a life annuity), and (ii) providing for a fixed and relatively late distribution date or schedule (payments for life starting at age 80) and giving the service recipient the right to accelerate payments. The proposed regulations do not address this issue very explicitly, but they appear to treat deferrals as bootleg accelerations by requiring nondiscretionary distribution schedules and limiting service recipient deferrals to specifically permitted situations, e.g., when it is administratively impracticable to pay on time.

4. Acceleration is permissible under the following circumstances:

i. *Accelerating Vesting Thereby Accelerating Payment*: Acceleration of vesting, including payment when tied to vesting, is not a prohibited acceleration.[105]

ii. *DROs*: Accelerated payments to an alternate payee are permissible when made pursuant to a domestic relations order.[106]

iii. *Conflict Resolution*: Acceleration is permitted if it is needed to comply with a Section 1043(b)(2) certificate of divestiture to deal with federal government official conflicts of interest.[107]

iv. *Tax Payment*: Acceleration is permitted to pay FICA taxes and income tax withholding on deferred amounts[108] or as needed to permit a Section 457(f) plan participant to pay taxes when benefits vest (determined using the withholding rate).[109]

v. *$10,000 or Smaller Cashouts*: A plan (determined after aggregation of all arrangements of the same type) may fully cash out a participant before the later of December 31 of the year in which the participant separates from service or the 15th day of the third calendar month after separation, if the cashout amount does not exceed $10,000.[110]

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[97] Prop. Treas. Reg. § 1.409A-2(a)(10) (also defining ''commissions''), 1.409A-2(b)(6), Examples 7-8.

[98] *See* Prop. Treas. Reg. § 1.409A-2(b)(6) Example 11.

[99] Prop. Treas. Reg. § 1.409A-2(a)(12).

[100] Prop. Treas. Reg. § 1.409A-2(c).

[101] IRS Notice 2005-1 Q&A-21.

[102] IRS Notice 2005-1 Q&A-20(a), also providing an exemption from constructive receipt as to such elections.

[103] Prop. Treas. Reg. § 1.409A-3(h)(1); IRS Notice 2005-1 Q&A-15(a). The Blue Book, at 472, states that the prohibition on accelerating payments does not apply ″merely because a plan provides a choice between cash and taxable property if the timing and amount of income inclusion is the same regardless of the medium of the distribution.″ It gives as an example offering a participant a choice between an immediately taxable lump sum and an immediately taxable annuity contract.

[104] See preamble to proposed regulations at V.B., 70 Fed. Reg. 57,943 (Oct. 4, 2005) stating that ''to avoid application of the initial deferral rules, a plan may not provide a service provider or service recipient with ongoing discretion as to the time and form or payment, but rather must set the time and form of payment no later than the time the service provider obtains a legally binding right to the compensation.''

[105] Prop. Treas. Reg. § 1.409A-3(h)(1); IRS Notice 2005-1 Q&A-15(a).

[106] Prop. Treas. Reg. § 1.409A-3(h)(2)(i); IRS Notice 2005-1 Q&A-15(b).

[107] Prop. Treas. Reg. § 1.409A-3(h)(2)(ii); IRS Notice 2005-1 Q&A-15(c).

[108] Prop. Treas. Reg. § 1.409A-3(h)(2)(v); IRS Notice 2005-1 Q&A-15(f).

[109] Prop. Treas. Reg. § 1.409A-3(h)(2)(iii); IRS Notice 2005-1 Q&A-15(d).

[110] Prop. Treas. Reg. § 1.409A-3(h)(2)(iv); IRS Notice 2005-1 Q&A-15(e). Such a provision can be added to a plan with respect to both past and future deferrals.

vi. *Certain Larger Cashouts*: A plan may provide for a lump sum cashout of benefits less than a specified amount when benefits attributable to deferrals after the cashout provision was implemented become payable.[111]

vii. **Payment When Amounts Are Taxed Under Section 409A*: A plan may permit acceleration of the amounts needed to pay the tax due under Section 409A as a result of a failure to comply with Section 409A, but not more than that amount.[112] The need for this provision and the rationale for its limit on distributions is unclear. Consider a simple example: A service provider defers fully vested compensation for 10 years under a noncompliant plan. Assume this is the only plan subject to Section 409A. The service provider is taxed on the entire deferral in the deferral year. If more than the amount needed to pay that tax is distributed, what additional penalty could there be for violating Section 409A *again*? If the situation is more complex, for example, there is another plan that would be aggregated, the paradox is no less apt.

viii. **Canceling Deferral Elections on Account of Unforeseeable Emergencies and Section 401(k) Plan Hardship Withdrawals*[113]

ix. **Cashouts in Connection with Certain Plan Terminations*: A plan may be terminated and benefits may be cashed out in connection with the service recipient's dissolution, bankruptcy, or change-in-control, its termination of all plans of the same type, or under circumstances to be permitted in future IRS guidance, but only in each case if strict requirements are met.[114]

x. **To Avoid a "Nonallocation Year" Under I.R.C. Section 409(p) Relating to Certain ESOPs, Subject to Certain Limits*[115]

xi. **Certain Linkages to Qualified Plans*: Just as the initial election rules are not violated by certain usual linkages between qualified and nonqualified plans, neither is the prohibition on accelerations violated by the same linkages.[116] The special 2005 transition rule permitting nonqualified plan ''mirror'' distribution elections, described in paragraph III.D.7.ii, does not apply to mirror *contribution* elections.

xii. *Timing and Payment Form Changes in 2005*: A special transition rule permits payment elections to be changed during 2005 with respect to deferred compensation subject to Section 409A. It also permits fixed distribution schedules that comply with Section 409A to be implemented or elected during 2005 as to Section 409A-governed stock options or SARs. [117]

xiii. *Cancellation of Pre-2006 Deferral Elections, Including Plan Termination, in 2005*: A similar transition rule permits deferral elections to be cancelled in whole or in part by the service provider or recipient pursuant to a plan amendment (that need not apply to participants generally) permitting cancellation that is adopted before the end of 2005, but only if the cancelled deferrals are taxable in 2005 or, if later, when they first vest.[118] For example, this transition rule would permit an employer to terminate a deferred compensation plan in 2005 and cash participants out. After 2005, this will not be possible.

D. Improper ''Second'' Elections: Section 409A(a)(4)(C) prohibits distribution timing and form elections from being changed unless the ''second'' election is made at least one year before the affected payment would otherwise be made (*or would commence as to an annuity or installment payments treated as a single payment), is not effective for 12 months, and defers the payment (or the annuity or installment payment benefit commencement date) for at least five years except in the event of death, disability, or unforeseeable emergency.[119] *The proposed regulations clarify many things about this ''second election'' rule, such as that this rule is applied separately with respect to each of several alternative payment triggering events (e.g., payment in a lump sum at the earlier of death or separation from service).[120]

1. This second election rule clearly applies to service provider elections; it is unclear whether it applies to service recipient elections.

2. *The proposed regulation clarify that second elections can be made as to separate payments that are part of a stream of payments, other than certain life annuities but, in the case of a series of installment payments, only if the plan provides that each payment is to be treated as a separate payment. Plans in existence before 2007 may be retroactively amended by Dec. 31, 2006, to specify separate payment treatment.[121]

3. *The second election rule, therefore, need not prevent a deferred compensation plan from permitting a participant to make separate distribution timing and form ''first'' elections as to each year's deferrals when making new deferral elections as long as it will result in a separate ''payment.''

4. *Another consequence of the separate payment rule is that annuities and installment distributions that are treated as a single payment can be modified in certain ways without regard to the second election rule or other Section 409A prohibitions. For example, a service provider may be permitted to choose a different form of annuity that is also treated as a single payment, as long as the new and old forms are actuarially equivalent and the annuity has not yet commenced.[122] Likewise, if installments are treated as a single payment, the prohibition on payment acceleration does not prohibit an otherwise proper second election deferring the commencement date of installments but otherwise accelerating them.[123]

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[111] Prop. Treas. Reg. § 1.409A-3(h)(2)(iv)(B); IRS Notice 2005-1 Q&A-15(e). Such a provision can only apply to deferrals made after the provision is in effect.

[112] Prop. Treas. Reg. § 1.409A-3(h)(2)(vi).

[113] See note 132.

[114] Prop. Treas. Reg. § 1.409A-3(h)(2)(viii).

[115] Prop. Treas. Reg. § 1.409A-3(h)(2)(ix).

[116] Prop. Treas. Reg. § 1.409A-3(h)(3), setting forth circumstances substantially identical to those in Prop. Treas. Reg. § 1.409A-2(a)(8).

[117] IRS Notice 2005-1 Q&A-19(c).

[118] IRS Notice 2005-1 Q&a-20(a), also providing an exemption from constructive receipt as to such elections. Q&A-18(a) states that termination and cashout will not be a material modification that will cause a loss of grandfathering.

[119] *See* Prop. Treas. Reg. § 1.409A-2(b), 1.409A-2(b)(6) Examples 14 (deferring commencement), 16 (switching from lump sum to life annuity), 17 (switching from life annuity to lump sum), 20 (adding an alternative distribution triggering event).

[120] Prop. Treas. Reg. § 1.409A-2(b)(4).

[121] Prop. Treas. Reg. § 1.409A-2(b)(2), 1.409A-2(b)(6) Example 18.

[122] Prop. Treas. Reg. § 1.409A-2(b)(2)(ii). It is not clear that this is permissible even if the commencement date is accelerated. Prop. Treas. Reg. § 1.409A-2(b)(3) may prohibit that.

[123] Prop. Treas. Reg. § 1.409A-2(b)(3), 1.409A-2(b)(6) Example 19 (switching from installments to a deferred lump sum).

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5. *Section 409A is not violated by delaying payments under certain circumstances if the plan so provides (but the elimination of a delay rule may improperly accelerate payments. The allowable delay circumstances are (i) delaying the payment of an amount that is not deductible because of the Section 162(m) $1 million limit on deductible compensation until it can be paid deductibly or, if earlier, the calendar year in which the service provider separates from service;[124] (ii) delaying a payment that would violate a bona fide loan covenant or similar contractual provision if the violation would cause the service recipient material harm and the payment is made as soon as permitted under the loan covenant or similar contractual provisions or, if earlier, when making the payment would not materially harm the service recipient;[125] (iii) delaying a payment that would be unlawful until it can be lawfully paid;[126] and (iv) delaying it under other circumstances as permitted in future IRS guidance. [127]

6. It remains unclear whether a beneficiary can be given the right to elect when and how distributions are to be made after the death of the participant.

7. Certain changes that would otherwise violate the second election rule are allowed.

i. *Timing and Payment Form Changes Elected in 2005*: See paragraph III.C.4.xii, *supra*.

ii. *Qualified Plan ''Mirror'' Elections in 2005*: Many deferred compensation plans, particularly SERPs and excess plans, provide that the time and form of their benefit payments will mirror the time and form of benefit payments to the participant under a companion qualified plan. Most qualified plans permit participants to elect the time and form of payment in ways that would violate Section 409A if qualified plans were subject to it. Therefore, nonqualified deferred compensation mirror provisions will violate Section 409A; however, for 2005-2006, a special transition rule permits mirror distribution provisions in effect on Oct. 3, 2004, to be honored. [128]

E. Improper In-Service Distributions: Section 409A(2)(A)(i) prohibits distributions except on account of the following events[129]: the service provider's separation from service,[130] disability[131] or death, at a fixed time or pursuant to a fixed schedule specified under the plan,[132] or on account of an unforeseeable emergency[133] or change-in-control.[134]

1. *Except as to distributions under the fixed time/fixed schedule exception, it is permissible for the date of the distribution (or the commencement of distributions) to be either specified or to be a date or calendar year that is objectively determinable at the time the event occurs, e.g., three months after disability first occurs. If an objectively determinable calendar year is specified and no other specific payment date within the year is objectively determinable, the payment date for ''second election'' purposes is deemed to be the first day of the calendar year in which payment is to occur.[135]

2. *Alternative allowable payment events may be specified, e.g., lump sum on the earlier of death or separation.[136] Each event may have its own payment form, e.g., lump sum on the first of the month following a preage 55 separation, but 5 substantially equal payments commencing on the first of the month following any later separation.[137]

3. *A payment is deemed to have been paid on its scheduled date if it is paid in the same calendar year as the scheduled date or no later than the 15th day of the third calendar month following the scheduled payment

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[124] Prop. Treas. Reg. § 1.409A-2(b)(5)(i).

[125] Prop. Treas. Reg. § 1.409A-2(b)(5)(ii).

[126] Prop. Treas. Reg. § 1.409A-2(b)(5)(iii).

[127] Prop. Treas. Reg. § 1.409A-2(b)(5)(iv).

[128] IRS Notice Q&A-23; preamble to proposed regulations, 70 Fed. Reg. 57,955 (Oct. 4, 2005).

[129] Prop. Treas. Reg. § 1.409A-3(a).

[130] Prop. Treas. Reg. § 1.409A-1(h) defines ''separation from service'' and ''termination of employment,'' including as to independent contractors. To comply with Section 409A, Plans almost certainly will need to use this definition if they provide for distributions triggered by a separation from service or termination of employment. A service provider who transfers among controlled group members presumably has not separated from service because Section 409A(d)(6) treats all such members as a single service recipient. *See* Prop. Treas. Reg. § 1.409A-1(g). A service provider who transfers to a noncontrolled group successor normally would have a separation from service. The ''same desk'' doctrine does not apply. See the preamble to the proposed regulations at VI.C, 70 Fed. Reg. 57,947 (Oct. 4, 2005).

[131] *See* Prop. Treas. Reg. § 1.409A-3(g)(4). Distributions on account of disability are allowable but only if (a) the disability is a medically determinable physical or mental impairment, (b) it can be expected to result in death or last for a continuous period of at least 12 months, and (c) either the disability prevents the individual from engaging in any substantial gainful activity or has resulted in the payment of income replacement benefits for at least three months under the employer's accident or health plan. *Id.*

[132] *See* Prop. Treas. Reg. § 1.409A-3(g)(1). The schedule must specify dates, not events. Therefore, for example, Section 409A would be violated if deferred compensation became payable because an executive's child goes to college. However, if the benefits vest just before they become payable (such as if they are paid when they vest), the short-term deferral exemption normally should be available. A provision that accelerates payment, for example, under a golden parachute agreement, if the employee is transferred to an affiliate or successor that does not assume the agreement likely would be an improper in-service distribution unless limited to transfers that are separations from service.

[133] *See* Prop. Treas. Reg. § 1.409A-3(g)(3). In-service distributions on account of an unforeseen emergency are allowable but only to deal with a severe financial hardship to the service provider or beneficiary that was caused by (a) the illness or accident of the service provider and certain related parties, (b) a casualty loss of the service provider's or beneficiary's property, or (c) ''other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the service provider or beneficiary.'' *Id*. The amount distributable may not exceed the amount necessary to satisfy the emergency (plus the taxes on the distribution), after taking insurance into account as well as liquidation of the participant's assets to the extent that liquidation would not itself cause a severe financial hardship. *Id*. Deferral elections can be cancelled (not merely modified) in the event of an unforeseen emergency for which a withdrawal from a Section 409A plan would be permitted, or when a hardship withdrawal from a Section 401(k) plan is made under Treas. Reg. § 1.401(k)-1(d)(2) (the proposed regulations incorrectly cite (d)(3)). Prop. Treas. Reg. § 1.409A-3(h)(2)(vii). When deferrals under a Section 409A-covered plan are cancelled for this reason, the amount that would have been contributed is treated as if it were a distribution to satisfy the unforeseen emergency, thereby reducing the amount that can be withdrawn for that purpose. Prop. Treas. Reg. § 1.409A-3(g)(3)(ii).

[134] *See* Prop. Treas. Reg. § 1.409A-3(g)(5). IRS Notice 2005-1 Q&A-11(a) permitted distributions on account of a corporate change-in-control. The proposed regulations incorporate substantially similar requirements except that distributions on account of a partnership change-in-control will be permitted, to be determined by applying analogous rules. See the preamble to proposed regulations at VI.E, 70 Fed. Reg. 57,948 (Oct. 4. 2005).

[135] Prop. Treas. Reg. § 1.409A-3(b).

[136] Prop. Treas. Reg. § 1.409A-3(b).

[137] Prop. Treas. Reg. § 1.409A-3(c).

date.[138] If it is not administratively practicable to calculate the amount due to events beyond the control of the service provider or his or her estate, or if making the payment would jeopardize the service recipient's solvency, the payment is deemed to have been paid on its scheduled date if paid during the first calendar year in which it is practicable to determine the amount or in which it can be paid without jeopardizing solvency.[139]

4. *If there is a bona fide service-recipient-refusal-to-pay, an affected payment will be deemed to have been paid on its scheduled date if (i) the service provider accepts payment of undisputed amounts the service recipient tenders other than in settlement of the claim, (ii) the service provider takes prompt and reasonable effort to collect the payment, and (iii) it is paid in the calendar year in which the dispute is settled, the service recipient concedes payment is due, or a final nonappealable judgment mandates the payment, whichever occurs first.[140]

5. *As to a person who becomes a resident alien and as to any amounts payable in or after the calendar year in which that occurs, Section 409A can be satisfied by amending the plan by the end of the calendar year in which the person becomes a resident alien to comply with the Section 409A's distribution requirements.[141]

6. *A plan may permit earnings, including dividend equivalents, credited on Section 409A deferred compensation to be paid on a nondeferred basis, provided that earnings for a calendar year are paid by the following March 15 and certain other requirements are satisfied.[142]

F. Improper Post-Separation Distributions: Section 409A(2)(B)(i) prohibits payments on account of termination of employment (other than death) from commencing during the six-month period following termination as to a ''specified employee''— essentially a key employee of a company whose securities are publicly traded on an established securities market or otherwise.[143]

1. *The plan must specify when payments that would have been made in the six months following separation will be paid. For example, they can be paid in a lump sum at the end of that period, or the whole distribution schedule can be pushed back to commence at the end of that period.

2. The service recipient can change the method by adopting an amendment that only will become effective at least 12 months later; this delayed effective date does not apply to an amendment made before the stock becomes readily tradable on an established securities market.[144]

3. For example, the six-month payment ban likely could be violated if a specified employee were given a contractually enforceable terminal leave of absence (a common severance benefit) that provides taxable benefits and that is not subject to an appropriate substantial risk of forfeiture. If the terminal leave constituted Section 409A-covered deferred compensation and the terminal leave were not respected and were treated as terminating the individual's employment, as usually would be the case,[145] the immediate commencement of terminal leave benefits would violate Section 409A.

4. The only permitted acceleration events (see paragraph III.C.4, *supra*) that permit distributions to be made before the end of the Section 409A(2)(B)(i)-required six-month delay period are the ones relating to domestic relations orders, conflicts of interest, and payment of taxes.[146]

G. Other Improper Plan Provisions: Section 409A also makes the following things taxable and subject to Section 409A penalties:

1. *Offshore Trust Funding,* as described in Section 409A(b)(1).

2. *Funding (Including Rabbi Trust Funding) Triggered by Employer's Financial Health* , as described in Section 409A(b)(2).

IV. Conclusion

Because Section 409A compliance can be arcane, no employer should treat this diagnostic guide as a substitute for the advice and counsel of a professional who is completely up-to-date with the latest Section 409A guidance and compliance know-how, which still is very much in flux. Every employer should have such a professional carefully review the census form the employer compiles with the assistance of this guide, and work with the employer to develop and implement sensible Section 409A compliance plans for nonexempt plans.

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[138] Prop. Treas. Reg. § 1.409A-3(d).
[139] Prop. Treas. Reg. § 1.409A-3(d).
[140] Prop. Treas. Reg. § 1.409A-3(e).
[141] Prop. Treas. Reg. § 1.409A-3(f).
[142] Prop. Treas. Reg. § 1.409A-2(a)(13), 1.409A-2(b)(6) Example 15.
[143] Key employee determinations generally are to be made pursuant to Section 416(i). See Prop. Treas. Reg. § 1.409A-1(i) for guidance on key employee determinations, and providing some special flexibility as to such determinations. Because ''key employee'' determinations can be troublesome to make, employers should consider imposing key employee limitations on all plan participants, or at least on any participant who could be a key employee

[144] Prop. Treas. Reg. § 1.409A-3(g)(2).
[145] Prop. Treas. Reg. § 1.409A-1(h)(1)(ii).
[146] Prop. Treas. Reg. § 1.409A-3(g)(2).

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Section 409A Plan Census Form (Asterisks indicate significant changes.)

SECTION 409A PLAN CENSUS FORM

Plan Type	Plan Name	409A-Exempt?	409A-Compliant?
Retirement, Savings, & Deferred Compensation Plans of all Types, Including SERPs & Excess Plans			
*Expense Reimbursements			
LTIPs & Bonuses			
Commissions, Royalties & Residuals			
Phantom Stock, Stock Appreciation Rights (SARs), & Similar Equity Programs			
Deferred Delivery Stock or Other Property, *e.g.*, After Option Exercise			
Dividend Equivalents			
Options to Buy Stock, Partnership Interests, or Other Property			
Restricted Property Transfers			

Plan Type	Plan Name	409A-Exempt?	409A-Compliant?
Severance, Retention, Exit Incentive, Window, or Parachute Benefits			
Contingent Event Benefits, *e.g.*, Special Bonus if Company is Sold			
Split-Dollar Life Insurance			
Post-Employment Benefits			
Individual Oral or Written Agreements (Including Settlements) with any of the Foregoing Features That Is not Listed Above			
Any Other Arrangement that Has the Effect of any of the Foregoing and That Is not Listed Above			

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