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Final 409A regs clarify deferred compensation rules for nonqualified plans

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In April of 2007, the IRS issued comprehensive final regulations relating to the Code Section 409A rules governing deferred compensation. The final regulations make several changes to the rules in the proposed regulations (released in September of 2005), taking into account comments the agency received on the proposed regulations. The final regulations (which are available in full text beginning at ¶12,147A of the CCH Pension Plan Guide) also add new rules that were not included in the proposed regulations. The following article summarizes the changes made, and the new rules added, by the final 409A regulations. This summary is only a very general discussion of these issues and is not intended as legal advice for any particular situation.

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409A REGS

Analysis of final 409A regs

This Extra Edition contains an in-depth analysis, by Barry K. Downey of Smith & Downey, P.A., of the long-awaited final regulations recently issued under Code Section 409A. Downey is a co-author of the Nonqualified Deferred Compensation Answer Book by Aspen Publishers, which is available in print or electronically (call 1-800-344-3734 to order).

Not only does this summary provide useful information about how the final rules differ from the proposed regulations issued in 2005, it also analyzes the new areas that are addressed by the final regulations but that were not included in the proposed regulations. Among the topics covered are the exemption for short-term deferrals, the independent contractor exemption, and other exemptions, as well as issues relating to stock rights, separation pay plans, and separation from service.

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Background

The American Jobs Creation Act of 2004, which was enacted on October 22, 2004, added Section 409A to the Internal Revenue Code containing several rules that apply to nonqualified plans. IRS Notice 2005-1, which provides guidance on the provisions of Code Section 409A, was released on December 20, 2004. A revised Notice 2005-1, with two clarifications, was published on January 10, 2005. On September 29, 2005, the Treasury issued proposed regulations under Code Section 409A. [70 Fed. Reg. 57930 (Oct. 4, 2005)] The 2005 proposed regulations incorporate much of the guidance provided in IRS Notice 2005-1, but also provide substantial additional guidance. On October 4, 2006, the IRS issued Notice 2006-79, which provided additional transitional relief for bringing nonqualified plans into compliance with Code Section 409A. On April 10, 2007, the Treasury issued final regulations under Code Section 409A, which are effective January 1, 2008. [72 Fed. Reg. 19234 (April 17, 2007)].

Exemption for short-term deferrals

A payment that meets the definition of a "short-term deferral," will not be treated as deferred compensation for purposes of the requirements of Code Section 409A. A payment is considered a short-term deferral if the terms of the plan do not provide for a deferred payment and require that payments be made to the service provider (and the payments are actually or constructively received by the service provider) by 2½ months from the later of:

1. The last day of the service provider's taxable year; or
2. The last day of the service recipient's year, in which the amount is no longer subject to substantial risk of forfeiture.

For example, payments under a three-year bonus plan that requires payments be made within 2½ months after the year the bonus vests will not be subject to Code Section 409A.

A payment under an arrangement that could be paid later than the 2½ month deadline for short-term deferrals will not be treated as a short-term deferral, even if the payment actually is made within the 2½ month deadline. For example, if the arrangement provides for payment upon separation from service, a payment that actually is paid within the 2½ month deadline will not be treated as a short-term deferral, because the terms of the plan would allow a payment that could be later than the 2½ month deadline for short-term deferrals.

Although the plan is not required to contain a written provision specifying the relevant payment deadline for short-term deferrals, without such a provision, any payment that is made later than the 2½ month deadline is an automatic violation of Code Section 409A (unless payment cannot be made because of unforeseen administrative or economic impracticability). If the plan contains a written provision specifying the payment date, the rules permit additional limited discretionary payment delays (e.g., payment within the same calendar year) without subjecting the payments to the requirements of Code Section 409A.

For purposes of the short-term deferral exemption, a payment is treated as actually or constructively received on the date that the payment is included in income (e.g., included in income under Code Section 83, the economic benefit doctrine, Code Section 402(b), or Code Section 457(f)). For example, an amount under a 457(f) plan is treated as paid on the date the amount is included in income due to a lapse of a substantial risk of forfeiture. Therefore, an amount under a 457(f) plan that is included in income on the vesting date for that amount is treated as paid on that vesting date, even if the payment is not actually made on that date.

For purposes of determining whether the plan provides for a deferred payment, the service provider's or service recipient's right to make an election of a different payment date, schedule or event, is disregarded. If the plan permits such an election, a determination of whether the plan provides for a deferred payment is based on (1) if no election is made—the payment date, schedule, or event that applies if no election is made (2) if an election is made—the payment date, schedule, or event elected.

Under the final regulations, if a payment has not been designated as a separate payment (e.g., a life annuity or a series of installment payments treated as a single payment), any initial payments cannot qualify as a short-term deferral, even if paid within the short-term deferral period.

Other exemptions

In addition to the short-term deferral exemption from the application of Code Section 409A, the following will not be treated as deferred compensation for purposes of the requirements of Code Section 409A:

- Code Section 401(a) qualified plans (including certain foreign plans treated as qualified plans under Code Section 402(d) (certain plans with foreign situs trusts) and under ERISA Section 1102(i)(2) (certain Puerto Rico plans));
- Code Section 403(a) annuity plans;
- Code Section 403(b) plans;
- Code Section 408(k) SEPs;
- Code Section 408(p) SIMPLE plans;
- Code Section 457(b) eligible deferred compensation plans;
- Code Section 415(m) governmental excess benefit arrangements;

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- Any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan (all as defined for purposes of Code Section 457(f));
- Medical expense reimbursement arrangements that provide benefits that are excludable from taxable income under Code Sections 105 or 106 (medical expense reimbursement arrangements that provide benefits that are taxable are not eligible for this exemption);
- Nondiscounted stock options and nondiscounted stock appreciation rights that do not allow any additional deferral. This exemption applies to nonstatutory stock options and to statutory stock options (including incentive stock options under Code Section 422 and options (including discounted stock options) granted under Code Section 423);
- Amounts paid in connection with litigation between the service provider and the service recipient, including court awards and bona fide settlements (and attorney's fees incurred in connection with the claim); and
- The provision of educational assistance benefits (as defined in Code Section 127(c)) provided solely for the service provider.

Independent contractor exemption

Generally, Code Section 409A does not apply to deferred compensation arrangements between a service recipient and an independent contractor (other than a director), if the independent contractor provides significant services to two or more unrelated (to each other and to the independent contractor) service recipients during the independent contractor's taxable year in which amounts are deferred. Determining whether services are significant is determined separately for each trade or business in which the independent contractor is involved. Under a safe harbor in the Code Section 409A regulations, an independent contractor will be treated as providing significant services to more than one service recipient, if not more than 70 percent of the total revenue of the independent contractor's trade or business comes from any one service recipient. Under an additional safe harbor in the final regulations, this 70 percent threshold will be deemed to have been met for a year, if the service provider has actually met the 70 percent threshold in the three immediately preceding years, but only if, at the time of deferral, the service provider does not know of any reason the 70 percent threshold will not be met for the current year.

If arrangements between the service provider and unrelated service recipients qualify for the Code Section 409A exception, an arrangement between the service provider and a related service recipient also will be exempt, if the services for the related service recipient are bona fide, arise in the ordinary course of business and are substantially the same as the services for the unrelated service recipient. In addition, if the exception applies at the time the legally binding right to the payment arises, any change in the relationship between the independent contractor and the service recipient (e.g., the independent contractor becomes an employee of the service recipient) will not affect the exception.

Stock rights issues

To qualify for the exemption from Code Section 409A, stock options and stock appreciation rights must not allow for the further deferral of compensation and must not be discounted (with certain limited exceptions). To determine if the option is discounted, any reasonable valuation method can be used, but the final regulations provide safe harbor methods for stock not readily tradable on a securities market that are entitled to a presumption of reasonableness. The presumption will apply to a valuation that (1) is based upon an independent appraisal, (2) is based upon a repurchase formula that is generally applicable and qualifies as fair market value under Code Section 83, or (3) for valuing illiquid stock of a start-up corporation (a corporation in its first 10 years of business whose stock is not traded on an established securities market, and whose stock is not subject to a put or call right (other than the right of first refusal), and who is not expected to go public in the next 180 days or undergo a change in control in the next 90 days), is based upon a valuation by an expert in performing similar valuations.

The final regulations also clarify that certain modifications of an option will not be treated as a further deferral of compensation. The extension of an exercise period for an option that is "underwater" (the fair market value of the underlying stock does not exceed the exercise price) at the time of the extension will not be treated as a further deferral. Also, an extension of the stock right exercise period, that is not beyond the earlier of 10 years from the original grant date or the original maximum term of the option will not be treated as a further deferral.

The final regulations also clarify that a right to the payment of accumulated dividend equivalents that is contingent upon the exercise of a stock right will be treated as a reduction in the option price, causing the option to be deferred compensation subject to Code Section 409A. If the payment of the dividend equivalents is not contingent on the exercise of the option, the payment will be subject to Code Section 409A, but will not cause the stock right to be subject to Code Section 409A.

Separation pay plans

Generally, a program that provides for payments to a service provider following termination of services is subject to the provisions of Code Section 409A. To avoid confusion with the provisions of Code Section 457(e)(11), the Code Section 409A regulations label these programs as "separation pay arrangements." The final regulations include a generic exclusion from Code Section 409A for any separation pay that is not otherwise excluded (as discussed below) if the aggregate payments (not just the payments during any year) do not exceed the applicable dollar amount under Code Section 402(g)(a)(B) for the year of separation ($15,500 for 2007).

The Code Section 409A regulations exempt from coverage under Code Section 409A a separation pay arrangement that provides payments that:

- Are made upon an involuntary separation from service;
- In the aggregate, do not exceed the lesser of two times the service provider's annual compensation or two times the Code Section 401(a)(17) annual limit on compensation ($225,000 for calendar year 2007) for the year of separation from service; and
- End no later than December 31 of the second calendar year following the calendar year of separation from service.

The final regulations clarify that payments under a separation pay arrangement that do not exceed this limit will be exempt from Code Section 409A, even if payments under the separation pay arrangement exceed the limit. Only the payments in excess of the limit will be subject to Code Section 409A.

In addition, this exemption will apply to a voluntary separation from service under an early retirement window arrangement under which a group of service providers are given the option to voluntarily separate from service in exchange for additional benefits or incentives.

Generally, if separation pay is provided upon a voluntary separation from service, for purposes of the Code Section 409A requirements, there is no distinction between the separation pay arrangement and a deferred compensation arrangement that provides payments upon separation from service.

The final regulations confirm that the term "separation pay plan" (for purposes of Code Section 409A) refers only to deferred compensation that is contingent upon a separation from service and not to compensation that can be paid without a separation from service (e.g., upon a change in control). Therefore, a payment that is contingent upon separation from service, and that is not deferred compensation (e.g., accelerated vesting of stock options that are not subject to Code Section 409A), is not a separation pay plan for purposes of Code Section 409A.

The Code Section 409A regulations make it clear that a separation pay arrangement will not be excluded from coverage under Code Section 409A if the separation pay is a replacement or substitute for deferred compensation payments that would otherwise be subject to Code Section 409A. Therefore, if the separation pay was obtained in exchange for a payment of deferred compensation subject to Code Section 409A, the separation pay will be treated as the payment of the deferred compensation.

The final regulations provide that a payment that is paid following separation from service, even though another payment was forfeited upon separation from service, is presumed to be separation pay obtained in exchange for a payment of deferred compensation. This presumption can be rebutted if it can be shown that the payment upon separation from service would have been paid regardless of the forfeiture of the unvested right. One factor that can rebut this presumption is if the payment upon separation from service is substantially less than the forfeited amount multiplied by a fraction whose numerator is the period of service completed by the service provider, and whose denominator is the period of service required to be completed to have vested in the forfeited payment. Another factor is if the payment upon separation from service customarily is paid to service providers by that service recipient (e.g., the payment of unused accrued leave).

The final regulations include provisions for determining whether a separation from service is involuntary. Under the final regulations, the characterization (in the documentation) of the separation from service by the service provider and the service recipient as voluntary or involuntary creates a rebuttable presumption that the characterization is correct. In addition, a voluntary separation from service for good reason may be treated as an involuntary separation from service, if the service recipient has taken an action (or actions) that result in a material negative change in the service provider's relationship with the service recipient (e.g., change in duties, or change in conditions under which duties are performed).

The final regulations provide a safe harbor for treating a voluntary separation from service for good reason as an involuntary separation from service. To meet the safe harbor, the separation from service must occur within one year following the initial existence of the good reason condition and the amount, time and form of payment for the voluntary separation from service must be the same as the amount, time and form of payment for an involuntary separation from service. In addition, the service provider must provide notice of the good reason condition within 90 days of its initial existence, and must give the service recipient at least 30 days to correct the good reason condition.

Under the safe harbor, a good reason condition includes one or more of:

1. A material reduction of the service provider's base compensation;
2. A material reduction of the service provider's responsibilities, duties, or authority;
3. A material reduction of the responsibilities, duties, or authority of the supervisor of the service provider (including a change in the service provider's supervisor to a supervisor with materially less authority, duty, or responsibility);
4. A material reduction in the service provider's budget; or
5. A material breach by the service recipient of the service provider's employment contract.

The Code Section 409A final regulations exempt from coverage under Code Section 409A certain types of reimbursement arrangements that are paid to the terminated service provider (or paid directly to the person providing the goods or services to the terminated service provider) before the end of the second calendar year after the calendar year in which the termination of services occurs (or for taxable medical benefits, by the later of this date, or the end of the COBRA period (even if COBRA coverage is not elected)). For expenses incurred by the service provider that qualify for the exemption, the time period is extended by the final regulations to the end of the third year following the separation from service. If reimbursements continue beyond the time period for this exemption, the reimbursements paid within the time period still will be exempt. The types of reimbursements arrangements that are excluded are arrangements that provide reimbursements:

- That are otherwise excludible from gross income;
- For expenses that are deductible by the service provider under Code Section 162 or Code Section 167 (business expenses);
- For outplacement expenses;
- For moving expenses (including the amount of any loss incurred due to the sale of a residence); or
- For medical expenses.

Definition of plan

Under the Code Section 409A proposed regulations, all amounts deferred for a service provider under all plans of the service recipient of the same category are treated as deferred under a single plan. The proposed regulations specified four categories of plans: (1) all amounts deferred under any account balance plan; (2) all amounts deferred under any nonaccount balance plan; (3) all amounts deferred under any separation pay plan that provides separation pay upon an involuntary separation from service, or upon an election to participate in an early retirement window program; and (4) all amounts deferred under any other type of plan. To these categories, the final regulations add the following categories of plans that are treated as a single plan: (1) split-dollar life insurance arrangements; (2) plans providing for the reimbursement of expenses incurred (or providing in-kind benefits), to the extent the benefits or reimbursements are not a substantial portion of the service provider's compensation; (3) stock rights that constitute nonqualified deferred compensation; (4) the elective deferral portion of any account balance plan, if separately identified; (5) the nonelective (including matching contributions on elective deferrals) portion of any account balance plan, if separately identified; and (6) amounts deferred under any foreign plan (provided the amounts deferred would have been treated as foreign earned income and the foreign plan is not substantially identical to a domestic plan of the service recipient).

Written plan "savings clauses"

The final regulations under Code Section 409A provide that a "savings clause" (a plan provision that nullifies any noncompliant plan provision) will not be effective. It is not clear whether this regulatory provision, which itself attempts to nullify these fairly common savings clauses, would be upheld by any court.

Substantial risk of forfeiture

One of the most controversial provisions of IRS Notice 2005-1 and the Code Section 409A proposed regulations is the definition of substantial risk of forfeiture, which is a central concept to the application of Code Section 409A. Code Section 409A(d)(4) defines substantial risk of forfeiture as follows: "The rights of a person to compensation are subject to a substantial risk of forfeiture if such person's rights to such compensation are conditioned upon the future performance of substantial services by any individual."

Code Section 409A(e)(5) delegates to the Secretary of the Treasury the responsibility to issue regulations that "may be necessary or appropriate to carry out the purposes of this section, including regulations … (5) disregarding a substantial risk of forfeiture in cases where necessary to carry out the purposes of this section."

The final regulations provide that a payment conditioned upon an involuntary separation from service (including certain voluntary separations from service for good reason) may be treated as a subject to a substantial risk of forfeiture.

Initial deferral election rules

Code Section 409A generally requires that participant deferral elections must be made by the end of the calendar year prior to the calendar year in which the compensation to be deferred will be earned. Midyear changes to these elections are prohibited. A deferral election includes an election as to the time of the payment, the form of the payment, or both the time and form of the payment (but does not include an election as to the medium of payment). Under an exception to this rule, newly eligible participants have 30 days from their eligibility date (i.e., the date the service provider is eligible to accrue an amount of deferred compensation) to make a prospective election to defer compensation not yet earned. Under another exception to this rule, elections to defer "performance-based compensation" measured over a period of at least 12 months must be made no later than six months prior to the end of the measurement period. For this purpose, "performance-based compensation" is to be defined by the IRS ("with a meaning similar to that used under Code Section 162(m)"), and must be variable and contingent on satisfaction of pre-established organizational or individual performance criteria specified in writing within 90 days after the service period begins and not readily ascertainable at the time of participant's deferral election.

An arrangement that does not permit deferral elections by the service provider must set the time and form of payments no later than the later of (1) the last date the service provider would have been permitted to make an election (if such an election was available to the service provider) or (2) the date the service provider obtains a legally binding right to the compensation.

Newly eligible participants have 30 days from their eligibility date (i.e., the date the service provider is eligible to accrue an amount of deferred compensation) to make a prospective election to defer compensation not yet earned. The final regulations provide that the special rule for newly eligible participants applies to each plan (applying the plan aggregation rules to determine the plan). In addition, a rehired service provider can be treated as a newly eligible participant, if the service provider has not participated (accruing benefits) in the plan for at least 24 months. In addition, the final regulations provide a special timing rule for nonelective excess benefit plans (nonqualified plan providing benefits not available under a qualified plan because of Code Section limitations applicable to the qualified plan). Under this special rule, a participant in the excess benefit plan is treated as newly eligible as of the first day of the first taxable year (of the service provider) immediately following the first year the service provider accrues a benefit under the excess benefit plan.

The Code Section 409A final regulations clarify the initial deferral election requirements for separations from service. Under this clarification, if there is no prior right to separation pay, and the separation pay is part of a bona fide, arms length negotiation (e.g., negotiated at the time of the separation), the initial deferral election (both the choice of current or deferred payment and the form and time of payment) can be made at any time before the service provider obtains a legally binding right to the payment (even if the services already have been provided).

The Code Section 409A final regulations also clarify that an election to annualize (i.e., pay over 12 months) compensation earned over a period of less than 12 months (e.g., teacher compensation for 10 months of services), must be made before the period of services begins, and none of the pay can be deferred to a date that is after the last day of the 13th month following the first day that the period of services begins.

Distribution events

Code Section 409A limits the times at which distributions may be made from nonqualified plans to only the following:

- Separation from service (plus six months if the participant is a Key Employee of a public employer);
- Disability;
- Death;
- A "time" or fixed schedule specified at the date of deferral;
- Change of control; or
- Unforeseeable emergency.

Time and form of payment

The Code Section 409A final regulations clarify that a single time and form of payment must be specified with respect to each payment that is payable on a payment event (unless there is an explicit exception to this requirement). However, the final regulations permit the designation of a different time and form of payment depending on whether the payment event occurs before or after a specified date, and the limited ability to designate a different time and form of payment depending on the conditions of separation from service (e.g., one form of payment for a separation from service before a specified age and a different form of benefit for a separation from service on or after a specified age). In addition, the final regulations continue to permit a different time and form of payment to be designated for each type of payment event.

The Code Section 409A final regulations require the plan to specify an objectively determinable date or year following a distribution event upon which the payment is to be made (e.g., 90 days after the separation from service or the year following death). This does not mean that the payment must be made on that exact date or year, if it is not administratively feasible to do so, and the payment will be treated as paid on the designated date if it is paid by the later of: (1) the 15th day of the third month following the designated date or payment event; or (2) the last day of the calendar year containing the designated date or payment event.

Under the Code Section 409A final regulations, the right to reimbursement or in-kind benefits will meet the fixed time and form of payment requirement, if:

1. The plan provides for reimbursement during an objectively prescribed period;
2. The expenses incurred and in-kind benefits available in one taxable year (of the service provider) will not affect the amount of reimbursements and in-kind benefits available in a different taxable year;
3. The reimbursement must be made no later than the last day of the service provider's taxable year following the taxable year in which the expense was incurred; and
4. The reimbursement or in-kind benefit cannot be subject to liquidation or exchange for another benefit.

The Code Section 409A final regulations provide that payment schedules with fixed or objective formula limitations can meet the requirement of a fixed schedule or time and form of payment, if (1) the fixed or objective formula is set on or before the date the time and form of payment must be set; (2) the fixed or objective formula is a nondiscretionary, objectively determined limitation on the amount that may be paid during a period and the factors for making the determination are beyond the control of the service provider and not subject to the discretion of the service recipient; and (3) the plan specifies the time and form of payment of any amount in excess of the limitation. However, any change in the limits or allocation method will be treated as a change in the time and form of payment and must meet the requirements for such a change.

For tax gross up payments, the Code Section 409A final regulations provide that the fixed time and form of payment requirement will be met if the plan provides that the tax gross up payment will be made and the payment is made by the end of the taxable year (of the service provider) immediately following the taxable year that the taxes are remitted to the taxing authority. In addition, a payment under a plan that provides the reimbursement of expenses incurred in a tax audit or litigation will meet the fixed time and form of payment requirement, if the plan provides that the payment will be made, and the payment is made, by the end of the taxable year (of the service provider) immediately following the later of (1) the year the taxes are remitted (if taxes are due), or (2) the year in which the audit or litigation is completed (if no taxes are due).

The Code Section 409A final regulations provide that payment schedules that are based on the timing of payments to the service recipient (e.g., a payment equal to 10 percent of accounts receivable collected by the service provider) will not meet the fixed time and form of payment unless (1) the payments to the service recipient are not from an entity that is part of the service recipient (e.g., a parent or subsidiary); (2) the payments must be bona fide routine transactions in the ordinary course of business of the service recipient, and the service provider must not have effective control over the service recipient (at the time the payments are due), over the payer of the payments, or over the collection of the payments; (3) the payment schedule must provide a nondiscretionary, objective method of determining the customer payments used in the calculation and a nondiscretionary, objective payment schedule (e.g., payment on March 1 of 10 percent of the payments collected in the previous year); and (4) the sales taken into account for determining the payment are of a type that is a frequent part of the service recipient's trade or business, and all such sales are taken into account or there is a legitimate, nontax business purpose for limiting the sales taken into account.

Separation from service

Under Code Section 409A, a determination of separation from service is based upon an objective determination of whether the service provider continues to provide significant services to the service recipient. A separation of service does not occur for military leave, sick leave, or another type of non-disability leave of absence lasting no more than six months (or lasting as long as reemployment rights are protected by a statute or contract, if these rights are protected for longer than six months). If a non-disability leave of absence lasts longer than six months (or last longer than the period of statutory- or contract-protected reemployment rights), a separation of service is deemed to occur on the first date immediately following the six-month (or longer protected) period. The Code Section 409A final regulations provide that for any disability leave (defined as the inability to perform the same or similar employment because of a medically determinable physical or mental impairment that is expected to end in death or last for at least six months), the employment relationship is deemed to continue for 29 months, unless the employment relationship is otherwise terminated by the service recipient before the end of the 29 month period.

The Code Section 409A final regulations provide that if a service provider is providing services to a service provider as both an employee and an independent contractor, or both as a director and an independent contractor, the service provider will not be treated as having a separation from service, unless the service provider separates from service both as an employee (or director) and as an independent contractor. However, if the service provider is providing services as an employee and as a director to a service provider and does not participate in a nonqualified deferred compensation plan that is aggregated for both types of services (i.e., the plan for services as an employee is separate from the plan for services as a director), the services as a director are not taken into account for determining if a separation from service as an employee has occurred (and vice versa).

The Code Section 409A regulations contain a safe harbor for determining whether an employee will, or will not, be treated as continuing to provide significant services as either an employee or an independent contractor. Under this simplified standard, an employee will be presumed (a rebuttable presumption) to have separated from service if the level of bona fide services as either an employee or an independent contractor is reduced to 20 percent or less of the average level of services performed over the immediately preceding 36 months. In addition, an employee will be presumed (a rebuttable presumption) not to have separated from service if the level of bona fide services as either an employee or an independent contractor is reduced to 50 percent or more of the average level of services performed over the immediately preceding 36 months. The presumptions can be rebutted by showing that the service provider and service recipient reasonably anticipated that the level of services would, or would not, be reduced to 20 percent or less (e.g., business circumstances, such as the termination of the employee's replacement, caused the employee to return to employment). There is no rebuttable presumption for a reduction of services to a level between 20 percent and 50 percent. The Code Section 409A final regulations also allow the plan to specify a different threshold (greater than 20 percent, but less than 50 percent) for a reduction of services that will be treated as a separation from service. To take advantage of this flexibility, the plan must specify the threshold for a separation from service on or before the date at which a separation from service is designated as a time of payment for a deferred amount, and must treat any change in the specified threshold as subject to the rules for subsequent deferrals and accelerations of payments.

For determining whether a separation from service with the service recipient has occurred, the service recipient definition is consistent with the controlled group rules under Code Section 414(b) and (c), but using 50 percent instead of 80 percent as the common ownership threshold. In addition, the plan can specify a different percentage threshold for this determination, that is no higher than 80 percent and no less than 20 percent, but a threshold of less than 50 percent must be for a legitimate business reason. In addition, the Code Section 409A final regulations allow a plan that is provided under a collective bargaining agreement to specify that a separation of service does not occur, if a service provider is reasonable expected to work for more than one employer covered by the collective bargaining agreement, and the employee stops performing services for one such employer and starts performing services for another such employer. However, the plan may not treat a service provider as separated from service if the service provider has not performed services for 12 months or less for an employer covered by the collective bargaining agreement, but is available to provide services for a participating employer during this period.

The Code Section 409A final regulations add a rule that allows the seller and buyer in a sale of assets by one service recipient to an unrelated service recipient to specify whether a service provider who provided to the seller services immediately before the sale and to the buyer immediately after the sale has incurred a separation from service, if (1) the sale is the result of bona fide, arm's length negotiations, (2) all similarly situated service providers are treated consistently, and (3) such treatment is specified no later than the closing date of the transaction.

Acceleration of payments

Generally, under Code Section 409A, a plan may not permit the acceleration of the time or schedule of any payment, including changes in the form of distribution that accelerate payments, except as provided under Treasury Regulations. For purposes of this rule, a payment of an amount in substitute for the payment of deferred compensation (e.g., a loan offset, a bonus) will be treated as a payment of the deferred compensation subject to the general prohibition against acceleration of the payment of deferred compensation. In addition, deferred compensation will be treated as paid, for purposes of this rule, on the date it is subject to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, or garnishment by creditors of the service provider or of the service provider's beneficiary.

Notwithstanding the general prohibition against acceleration of payments, the Code Section 409A final regulations continue to permit the discretionary termination and liquidation of a deferred compensation plan, but shorten the period during which the service recipient cannot adopt a new plan of the same type following the plan termination from five years to three years, and add a requirement that the discretionary plan termination not be related to a downturn in the financial health of the service recipient.

The Code Section 409A regulations permit a plan to provide that a deferral election terminates following an unforeseeable emergency distribution from the nonqualified plan or following a hardship distribution from a qualified 401(k) plan. The deferral elections must be terminated, rather than suspended, and a subsequent deferral election will then be treated as, and subject to the requirements for, an initial deferral election. In addition, the Code Section 409A final regulations permit the cancellation of a deferral election upon the disability of the service provider. Disability for purposes of this rule means the inability to perform the same or similar employment because of a medically determinable physical or mental impairment that is expected to end in death or last for at least six months.

Changes in the time and form of payment

Code Section 409A substantially limits a nonqualified plan participant's ability to make changes to previous distribution elections. Specifically, Code Section 409A provides that changes to delay distributions or change a form of distribution:

- May not take effect for 12 months;
- For a payment other than a payment on account of death, disability, or unforeseeable emergency, the first payment under a changed election must be deferred for at least five years from the date it otherwise would have been made; and
- For a payment at a specified time or pursuant to a fixed schedule, changes to a time or schedule specified at the date of deferral must be made at least 12 months prior to the first scheduled payment.

For purposes of these rules and the anti-acceleration rule, each separately identified amount in the plan (e.g., a lump sum of 40 percent of the account at age 60 and a lump sum at the balance of the account at age 65) will be treated as a separate payment. Installment payments will be treated as a single payment, unless the plan specifies that each payment will be treated as a separate payment. A life annuity is treated as a single payment. The Code Section 409A final regulations provide that certain features are ignored, for purposes of determining whether a payment form is a life annuity (but not for purposes of determining when two life annuities are actuarially equivalent), including: (1) term certain features; (2) pop-up provisions that increase payments upon the death of a designated beneficiary; (3) cash refund features that provide for payments upon the death of the last surviving annuitant; (4) social security or railroad retirement leveling features; and (5) cost-of-living features.

The Code Section 409A final regulations clarify the method for determining when two actuarially equivalent life annuities are treated as one form of payment. Under this clarification, a subsidized joint and survivor annuity is treated as actuarially equivalent to a life annuity, provided the annual lifetime and the annual survivor benefits do not exceed the annual lifetime benefit under the life annuity. In addition, the same actuarial factors must be used to determine if two life annuities are actuarially equivalent at any one time, but these factors can change at other times, and these factors need not be the same factors used for any qualified plan of the service recipient.

Generally, the addition of a payment event, the removal of a payment event, or the substitution of one payment event for another payment event will be treated as a change in the payment event that is subject to the anti-acceleration rule and the change in time and form of payment requirements. However, the Code Section 409A final regulations provide that the addition of death, disability, or an unforeseeable emergency as payment events that may occur earlier than the otherwise specified event, is not prohibited by the anti-acceleration rule. However, the anti-acceleration rule prohibits the addition of a fixed date or schedule, a change in control event, or separation from service as a potentially earlier payment event, or the amendment of the plan to remove a payment event that the plan term required payment upon the latest of two or more payment events. Also, under the Code Section 409A final regulations, the addition of death, disability, or an unforeseeable emergency as a payment event that will apply if later than the otherwise specified payment event, or the amendment of a plan to substitute death as a new payment event in place of a specified payment date, will be subject to the rules for subsequent changes in the time and form of payment. Thus, for example, if the plan is amended to substitute a change in control payment event for a separation from service payment event, the amendment would be permitted only if the change was not effective for at least one year, and the payment would occur only upon the later of a change in control event or at least five years after a separation from service.

Nonqualified plans linked to other arrangements

The Code Section 409A final regulations provide that a change in the amount of eligible compensation used under a nonqualified plan caused by a proper election, or change to an election, under a Code Section 125 cafeteria plan will not violate the anti-acceleration rule or change in form and time of payment requirements.

The Code Section 409A final regulations also provide that a plan provision that provides for a direct dollar for dollar offset of nonqualified deferred compensation benefits by the amount of payments received as social security benefits will not fail to provide for a fixed schedule of payments. Similarly, an offset of nonqualified deferred compensation benefits by the amount received from a service recipient's disability plan is permitted, if (1) a substantial number of service providers participate in the disability plan; (2) the disability plan is established before the date the service provider becomes disabled; and (3) any service recipient change to the disability plan does not violate the anti-acceleration rule.

Application of Code Section 409A and effective dates

IRS Notice 2005-1, which provides guidance on the provisions of Code Section 409A, was released on December 20, 2004. A revised Notice 2005-1, with two clarifications, was published on January 10, 2005. On September 29, 2005, the Treasury issued proposed regulations under Code Section 409A. [70 Fed. Reg. 57930 (Oct. 4, 2005)] These regulations incorporate much of the guidance provided in IRS Notice 2005-1, but also provide substantial additional guidance. On October 4, 2006, the IRS issued Notice 2006-79, which provided additional transitional relief for bringing nonqualified plans into compliance with Code Section 409A. On April 10, 2007, the Treasury issued final regulations under Code Section 409A, which are effective January 1, 2008. [72 Fed. Reg. 19234 (April 17, 2007)]

The transitional guidance of Notice 2005-1 provided two primary deadlines—March 15, 2005 and December 31, 2005. Although, generally, under Notice 2005-1, nonqualified plans that are subject to the rules under Code Section 409A (i.e., plans that are not exempt from the new rules and plans that are not grandfathered under the pre-AJCA rules) must be operated in compliance with the rules on January 1, 2005, plan amendments to bring the plan into compliance with the new rules could be adopted as late as December 31, 2005 (extended to December 31, 2007 under the IRS Notice 2006-7).

Pursuant to the transitional relief granted under IRS Notice 2006-79:

1. The deadline for amending plans to bring them into compliance with Code Section 409A was extended to December 31, 2007.
2. Plans can be amended to add or remove payment events or accelerate or delay payments, and participants can elect, or amend elections with respect to, the timing and form of benefit payments, through the end of 2007 without violating the acceleration of benefit and election requirements of Code Section 409A, as long as a 2007 election does not affect payments that are otherwise payable in 2007 or cause any other payments to be made in 2007.
3. A discounted stock option or stock appreciation right that would be subject to Code Section 409A can be replaced with a non-discounted option or right that is not subject to Code Section 409A, if the cancellation and reissuance occurs by December 31, 2007, and as long as this does not result in the cancellation of a deferral in exchange for cash or vested property in 2007.

The Code Section 409A final regulations do not change the previously specified effective dates and transitional relief under prior Code Section 409A guidance. The final regulations are generally effective January 1, 2008. However, certain transitional rules are included in the final regulations.

Code Section 409A applies to "amounts deferred after 2004," while pre-2005 deferrals remain subject to the pre-AJCA rules (so long as the pre-2005 plan is not "materially modified" after October 3, 2004). The AJCA legislative history and IRS Notice 2005-1 state that a deferral (whether an employee or an employer contribution) is not a "pre-2005 deferral" unless it was both deferred and vested before 2005. Therefore, "old money" that did not vest by December 31, 2004 is governed by the new rules. However, the Code Section 409A final regulations provide that the pre-2005 grandfathered amount includes the present value of any earned and vested right to future account credits, even if not credited as of December 31, 2004 (e.g., a bonus amount that is earned and vested as of December 31, 2004, but not calculated and credited until sometime in 2005).

For purposes of determining whether a material modification after October 3, 2004 has occurred, (1) a modification of a stock right that is not treated as a new grant of a stock right, or is not treated as a deferral under a stock right, will not be treated as a material modification; (2) an amendment to a plan to permit payments under a domestic relations order, or a payment pursuant to a domestic relations order, will not be treated as a material modification; and (3) the removal of a plan provision that required cancellation of deferrals for a prescribed time under all nonqualified deferred compensation plans, to receive a distribution from the grandfathered plan, will not be treated as a material modification.

Stock rights issued before April 10, 2007 that would constitute service recipient stock under the prior guidance, but would not be treated as service recipient stock under the final regulations, will continue to be treated as service recipient stock on and after April 10, 2007, until the exercise or termination of the right, or until the right is modified such that it is treated as a new right. Stock rights issued on or after April 10, 2007 will not be treated as service recipient stock after December 31, 2007, unless the stock meets the requirements for service recipient stock under the final regulations.

If a service provider would have been treated as separated from service before January 1, 2008 under a good faith interpretation of the guidance prior to the final regulations, but would not be treated as separated from service under the final regulations: (1) where payments have commenced before January, 1, 2008, the plan may continue the payments after 2007, or may halt the payments and amend the time and form of any remaining payment to comply with the final regulations; (2) where payments have not commenced before January 1, 2008, but all events necessary for payments to commence have occurred, the plan may make the payments after 2007, or may amend the time and form of all payments to comply with the final regulations. In addition, where payments have not commenced on or before December 31, 2007, because the service provider would not be treated as separated from service under the guidance prior to the final regulations, but would be treated as separated from service on or before December 31, 2007 under the final regulations, the plan must treat the service provider as having separated from service on a date between April 10, 2007 and December 31, 2007, inclusive.

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