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CLARK CONSULTING

Executive Benefits
BULLETIN

October 10, 2005

SUMMARY OF PROPOSED TREASURY REGULATIONS FOR §409A

CLARK CONSULTING'S COMPREHENSIVE ANALYSIS

On September 29, 2005, the Treasury Department and the IRS issued the second round of guidance for implementing the requirements of Internal Revenue Code §409A that apply to nonqualified deferred compensation arrangements. This guidance, which is more comprehensive than the initial guidance provided in Notice 2005-1 last December, is in the form of proposed Treasury regulations. The effective date for the proposed regulations is January 1, 2007; however, they can be fully relied upon by plan sponsors until the regulations become final.

In general, the proposed regulations incorporate the guidance contained in Notice 2005-1 and provide substantial additional guidance necessary for plan sponsors to bring their arrangements into operational and documentary compliance with the requirements of §409A. Importantly, the proposed regulations also provide for an extension of certain key deadlines (as summarized below) that were initially contained in Notice 2005-1, including a one year extension of the deadline for bringing plan documents into compliance with the requirements of §409A.

Highlights of Proposed Regulations

- Documentary Compliance Deadline Extended until December 31, 2006. Plan sponsors have until December 31, 2006 to bring their plan documents into compliance with the requirements of §409A — a one year extension of the deadline that was initially contained in Notice 2005-1.
- Distribution Election Deadline Generally Extended until December 31, 2006. The deadline to solicit new distribution elections for amounts subject to §409A is extended from December 31, 2005 to December 31, 2006 — a one year extension of the deadline that was initially contained in Notice 2005-1.
- Opportunity for Termination of Participation/Cancellation of Deferral Elections NOT Extended. Consistent with the deadline provided in Notice 2005-1, plan sponsors have until December 31, 2005 to provide participants with an opportunity to terminate participation in a plan or cancel an outstanding deferral election for amounts subject to §409A.
- "Performance-based Compensation" Defined. The proposed regulations include a definition of "performance-based compensation" – amounts earned over a period of at least 12 months for which deferral elections may be made up to six months before the end of the performance period. The definition in the proposed regulations appears to apply more broadly than had been anticipated.
- Changes to Distribution Elections. §409A provides that elections as to the time/form of payment may be changed if certain requirements are satisfied. The proposed regulations provide additional guidance on these rules, and appear to offer more flexibility than had been anticipated.

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Highlights of Proposed Regulations (Cont.)

- Deferral Elections for Fiscal Year Compensation. The proposed regulations include coordination rules that permit plan participants to make deferral elections for "fiscal year compensation" no later than the end of their employer's preceding fiscal year.
- Time for Identifying "Key Employees". §409A requires that distributions to "key employees" of public companies must be delayed for at least six months following separation from service. The proposed regulations include rules regarding when the determination of "key employee" status must be made.
- Guidance on Equity and Other Arrangements. The proposed regulations provide additional guidance and clarification on the application of §409A to many other types of arrangements, such as equity (e.g., stock options, SARs), severance/separation pay, foreign plans and split-dollar life insurance arrangements (included in the preamble to the regulations).

A more extensive summary of the proposed §409A regulations (referred to herein as "regulations") is included on the following pages.

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I. SUMMARY OF KEY DEADLINES PROVIDED IN THE REGULATIONS

Notice 2005-1 contained several key deadlines in order for plan sponsors to make a timely, and compliant, transition of an existing nonqualified deferred compensation arrangement to the requirements of §409A. The regulations generally incorporate the transition guidance provided in Notice 2005-1 and include an extension of certain key deadlines, as summarized more fully in the table below.

SUMMARY OF KEY DEADLINES PROVIDED IN THE REGULATIONS

Issue	Provisions in the Regulations
Documentary Compliance	Plan Must Be in Writing – In order to comply with the requirements of §409A, the regulations provide that any plan that is subject to §409A must be set forth in writing. Deadline Extended to December 31, 2006 – Notice 2005-1 provided that plan sponsors have until December 31, 2005, to bring their plan documents into compliance with the requirements of §409A. The regulations extend this deadline to **December 31, 2006**.
Operational Compliance	A plan must be operated in good faith compliance with the requirements of §409A beginning January 1, 2005, for amounts subject to §409A. The regulations provide the following guidance for this requirement: ◆ **Reliance on Regulations before January 1, 2007 is "Good Faith" Compliance** – The regulations will not become effective until January 1, 2007; however, if a plan is operated in compliance with the provisions in the regulations, the plan will be deemed to have been operated in "good faith" compliance with the requirements of §409A. ◆ **Reliance on Notice 2005-1 Permitted Through December 31, 2006** – Plan sponsors are not required to comply with the regulations until January 1, 2007. In the interim, plan sponsors may operate plans in compliance with the requirements of §409A and Notice 2005-1. However, to the extent an issue is not addressed in Notice 2005-1 or in other published guidance, the plan must follow a good faith, reasonable interpretation of §409A.
New Distribution Elections	Deadline Generally Extended to December 31, 2006 – The regulations incorporate the transition relief for distribution elections contained in Notice 2005-1, which provided a limited opportunity for participants to make new distribution elections for amounts subject to §409A. The regulations generally extended the deadline to utilize this transition relief from December 31, 2005 to **December 31, 2006**, subject to the limitation described below. Limitation on Providing this Opportunity in 2006 – The regulations provide that the transition relief for distribution elections described above cannot be utilized during the one year extension with respect to amounts that are payable in 2006 or amounts which would become payable in 2006 as a result of a new distribution election.
Cancellation of Deferrals or Termination of Plan Participation	Deadline in Notice 2005-1 is NOT Extended – The regulations incorporate the transition relief for deferral elections provided in Notice-2005-1 through which a participant may be provided an opportunity to cancel an outstanding deferral election or terminate participation in a plan for amounts subject to §409A. This deadline was not extended by the regulations; therefore, plan sponsors have until **December 31, 2005** to utilize this transition relief or offer it to participants.

II. DEFERRAL ELECTIONS

Overview

§409A generally requires deferral elections to be submitted before the end of the participant's taxable year (i.e., 12/31) preceding the service period, or at such other time as provided in Treasury regulations. Exceptions to this general rule include elections to defer "performance-based compensation" (as defined in the regulations) and deferral elections made during the first year in which an individual is eligible to participate in the plan. In addition, Notice 2005-1 provided transition guidance that permitted plan participants to terminate participation in the plan or cancel an outstanding deferral election for amounts subject to §409A, by December 31, 2005.

The regulations generally incorporate all of the rules above, and provide guidance on several key issues that were not addressed in the statute or in Notice 2005-1. The regulations also provide a new exception to the general timing rule for certain "ad hoc awards." This section summarizes the key rules that apply to elections to defer compensation subject to §409A.

Timing of Deferral Elections

Consistent with §409A, the regulations generally require deferral elections to be submitted before the end of the participant's taxable year (i.e., 12/31) preceding the service period, except as otherwise provided in the regulations. Regarding the timing of deferral elections in situations where the fiscal year of the employer differs from the taxable year of the participant, the regulations provide a coordination rule that allows a participant to make an election to defer any "fiscal year compensation" by submitting a deferral election no later the close of the employer's fiscal year preceding the fiscal year in which such compensation will be earned. The table below describes certain exceptions to the general timing rule(s) for deferral elections.

CERTAIN EXCEPTIONS TO THE GENERAL TIMING RULE(S) FOR DEFERRAL ELECTIONS

Issue	Provisions in the Regulations
Performance-Based Compensation	The regulations provide that in the case of "performance-based compensation" (as defined below) based on services performed over a period of at least 12 months, a deferral election may be made up to 6 months before the end of the service period. Guidance provided in the regulations to determine whether compensation qualifies as "performance-based compensation" includes: ◆ **Definition of "Performance-Based Compensation"** – The regulations define the term to include compensation where the amount of, or entitlement to, the compensation is contingent on the satisfaction of preestablished organizational or individual performance criteria relating to a performance period of at least 12 consecutive months. "Performance-based compensation" does not include any amount or portion of any amount that will be paid regardless of performance, or based upon a level of performance that is substantially certain to be met at the time the criteria are established. ◆ **Establishing Performance Criteria**. Performance criteria will be considered "preestablished" if it is established in writing no later than 90 days after the commencement of the performance period. It is not required that the performance criteria be approved by a compensation committee of the board of directors in order for payments based on such criteria to qualify as performance-based compensation. The regulations also require that the participant perform services continuously from no later than the date the performance criteria are established through the date of the deferral election.

CERTAIN EXCEPTIONS TO THE GENERAL TIMING RULE(S) FOR DEFERRAL ELECTIONS (CONT.)

Issue	Provisions in the Regulations
Performance-Based Compensation (Cont.)	◆ **Payments May be Based Upon Subjective Performance Criteria.** "Performance-based compensation" may generally include payments based upon subjective performance criteria if the subjective performance criteria relates to the participant, a group that includes the participant, or a business unit to which the participant provides services. However, this rule is subject to certain limitations. For example, the determination of whether or not the subjective performance criteria have been met cannot be made by the participant or a person who is under the supervision of the participant. ◆ **Equity Compensation May Qualify as "Performance-Based Compensation."** The regulations provide that compensation will be considered "performance-based compensation" if it is based solely on an increase in the value of the employer, or the employer's stock, after the date of a grant or award (i.e., pure appreciation, such as a stock option or a SAR). However, if the amount of compensation the participant will receive is not based solely on appreciation after the grant or award (e.g., a restricted stock unit or a discounted SAR) and such amount would not otherwise qualify as "performance-based compensation," the compensation attributable to the grant or award will not qualify as "performance-based compensation." However, an award of equity-based compensation may constitute "performance-based compensation" if the compensation is subject to a condition that would otherwise qualify as "performance-based compensation," such as a performance-based vesting condition.
First Year of Eligibility	During the first year in which an individual is eligible to participate in the plan, a deferral election can be made within 30 days of eligibility, but only as to services performed subsequent to the election. Guidance provided in the regulations for the application of this rule, includes: ◆ **Plan Aggregation Rules Apply** – The plan aggregation rules apply for the purpose of determining whether a participant may be considered newly eligible for a plan. As a result, a participant may generally only be "newly eligible" once for each category of "plan" (e.g., account balance plans, nonaccount balance plans, etc.) sponsored by his employer. ◆ **Method of Calculating Deferral Amount for Certain Compensation** – For compensation earned based on a specified performance period (e.g., an annual bonus), where the deferral election is made in the first year of eligibility but after the beginning of the service period, the regulations provide that the deferral election will be deemed to apply pro rata to the compensation, calculated based on the remaining days of the service period after the deferral election is made over the total length of the service period.
Compensation that is Subject to Risk of Forfeiture ("Ad Hoc Awards")	With respect to compensation (i) to which a participant has to a legally binding right to a payment in a subsequent year, and (ii) that is subject to a forfeiture condition requiring the participant's continued services for a period of at least 12 months from the date the participant obtains the legally binding right, the regulations provide that an election to defer such compensation may be made on or before the 30th day after the participant obtains the legally binding right (provided the election is made at 12 months in advance of the earliest date at which the forfeiture condition could lapse). ***Note that this exception was not contained in Notice 2005-1.***

Additional Guidance for Deferral Elections

The regulations provide additional guidance for deferral elections to be made in compliance with §409A, as described below.

ADDITIONAL GUIDANCE FOR DEFERRAL ELECTIONS

Issue	Provisions in the Regulations
Deferral Elections Must Be Irrevocable	A deferral election is not considered to be made for purposes of §409A until the election becomes irrevocable under the terms of the arrangement. The regulations clarify that a plan may allow a deferral election to be changed (without such election being considered revocable), provided that any change is made no later than the required deadline for making such deferral election under the regulations.
Commissions – Rule to Determine When the Service Period Begins	**General Rule.** The regulations provide that a participant is treated as having performed services for "commission compensation" (as defined in the regulations) only in the taxable year in which the customer remits payment (upon which the commission is derived) to the company. Therefore, a deferral election for "commission compensation" will be made in compliance with the requirements of §409A if the election is made no later than the December 31st preceding the taxable year in which the customer remits payment to the company. **Definition of "Commission Compensation".** For purposes of the rule described above, "commission compensation" is defined as compensation earned by a service provider if (i) a substantial portion of the services provided consist of the direct sale of a product or service to a customer, (ii) the compensation consists either of a portion of the purchase price or an amount calculated solely by reference to the volume of sales, and (iii) payment of the compensation is contingent on the employer receiving payment from an unrelated customer for the product or services.
"Evergreen" Elections are Permitted	A plan may allow "evergreen elections" (i.e., deferral elections that remain in effect until changed or revoked), provided that the election (or change to such election) becomes irrevocable no later than the required deadline for making such deferral election under the regulations. **Example:** An "evergreen" election to defer salary earned in 2007 could be changed, provided that the change becomes irrevocable no later than December 31, 2006.
Compensation Earned During Final Payroll Period ("Flop-Over Compensation")	Unless an arrangement provides otherwise, compensation that is (i) attributable to services performed during the final payroll period of a participant's taxable year, and (ii) payable in the subsequent taxable year, will be treated as compensation earned in that subsequent taxable year for purposes of applying the deferral election timing rules of §409A. **Example:** If an employer pays salary to its employees on a bi-weekly basis and the final payroll period for the year runs from December 24, 2006 through January 6, 2007, a participant will be deemed to have provided services during the calendar year 2007 with respect to the salary payable for that final payroll period (unless the employer's arrangement provides for an alternate treatment for such compensation). As a result, the employer will apply the participant's 2007 salary deferral election to all salary payable for such final payroll period. Note that without this rule, the employer in the example above would be required to "bifurcate" the final payroll in order to apply the participant's (i) 2006 salary deferral election to the portion of the salary earned in 2006, and (ii) 2007 salary deferral election to the portion of the salary earned in 2007.

Transition Relief for Deferral Elections Available Until December 31, 2005

The regulations incorporate the transition guidance for deferral elections provided in Q&A 20 of Notice 2005-1. Consistent with the deadline contained in the Notice, the regulations provide that plan sponsors have until December 31, 2005 to utilize this transition relief or make it available to participants. In particular , Q&A 20 of Notice 2005-1 provided that, at the employer's discretion, a plan may be amended to allow a participant to terminate participation in the plan or cancel an outstanding deferral election for amounts subject to §409A. If an employer chooses to offer participants the opportunity to terminate participation in a plan or to cancel a deferral election, (i) the plan must be amended no later than December 31, 2005 to reflect the options available to participants, and (ii) the amounts subject to the termination or cancellation must be includable in income of the participant in calendar year 2005, or if later, the taxable year in which the amounts are earned and vested.

III. DISTRIBUTION ELECTIONS

Overview

With respect to arrangements that allow participants to elect the form and/or timing of payment, the regulations provide specific guidance on (i) the deadline for making an initial distribution election, and (ii) the application of the rules of §409A regarding a change in the form or timing of payment.

Initial Distribution Elections

Elective Arrangements. For arrangements that provide participants with a deferral election, the regulations provide that if a plan allows participants to elect the form and/or timing of payment, the initial distribution election must be made at the time of initial deferral (i.e., no later than the time the participant's deferral election becomes irrevocable). If the plan provides for payment upon two or more permissible distribution events, a plan may provide that a different form of payment may be elected for each distribution event.

Nonelective Arrangements. For arrangements that do not provide participants with a deferral election (i.e., nonelective arrangements), the form and/or timing of payment must generally be specified under the plan or elected by participant no later than the time the participant has a legally binding right to the compensation.

Subsequent Changes in Form or Time of Payment

§409A allows a participant to change the form or timing of a payment, subject to specific requirements. The regulations provide significant guidance regarding the application of the rules for changing the form or timing of payment (such rules are referred to below as the "subsequent change rules"), as summarized below.

GUIDANCE REGARDING APPLICATION OF THE SUBSEQUENT CHANGE RULES

Issue	Provisions in the Regulations
General Rule under§409A	A participant may elect to change the form or timing of a payment, subject to the following requirements: (i) the election will not take effect until at least 12 months after the election is made; (ii) the payments that are subject to the election (excluding payments upon death, disability or unforeseeable emergency) must be delayed at least 5 years from the date the payments would have otherwise been made; and (iii) any election related to a *distribution at a specified time or pursuant to a fixed schedule* must be made at least 12 months prior to the date the payment is scheduled to be paid.
Definition of "Payment"	For purposes of the "subsequent change" rules, the term "payment" refers to each separately identified amount a participant is entitled to receive under a plan on a determinable date. An amount is separately identified only if the amount may be objectively determined (e.g., 10% of the account balance as of a specified date).

GUIDANCE REGARDING APPLICATION OF THE SUBSEQUENT CHANGE RULES (CONT.)

Issue	Provisions in the Regulations
Installment Payments	The guidance clarifies that a plan may treat a series of installment payments as either a single payment or a series of separate payments for purposes of applying the subsequent change rules. ◆ **Example— Installments Treated as a Single Payment:** If a participant is entitled to 5 annual installments designated as a single payment (rather than a series of separate payments) commencing on January 1, 2008, by no later than January 1, 2007, the participant may elect to receive the entire amount equal to the sum of all 5 of the installments as a lump sum payment on or after January 1, 2013. Because the installments were designated as a single payment commencing with the first payment on January 1, 2008, the remaining installment payments can be paid as part of the lump sum and are not required to be delayed five years – the five year delay is only measured from the first payment. ◆ **Example — Installments Treated as Separate Payments:** If a participant is entitled to 5 annual installments designated as a series of separate payments (rather than a single payment) commencing on January 1, 2008, by no later than January 1, 2007, the participant may elect to delay the first payment until January 1, 2013 or later. Because the installments were designated as a series of separate payments, the second installment would be paid as originally scheduled on January 1, 2009 (i.e., it would not be impacted by the change to the first installment). Any other installment in that series could be delayed by separately applying the subsequent change rules.
Life Annuities	The entitlement to a "life annuity" (as defined in the regulations) is treated as a single payment. Importantly, the regulations provide that if a participant makes a change in the form of payment from one type of life annuity to another actuarially equivalent type of life annuity before any payment has been made, the change will not be considered a change in the form or time of payment for purposes of §409A. ***Note that the ability to choose between actuarially equivalent life annuities without being considered a change in the form or timing of payment was not included in Notice 2005-1.***
Coordination with "Anti-Acceleration" Rules	The regulations clarify that a change in the form of a payment that results in a more rapid schedule for payments generally will not constitute an impermissible acceleration of a payment, provided that the change in the form of payment complies with the "subsequent change" rules. ***Note that this is a new and important clarification of the interrelationship between the "subsequent change" rules and the "anti-acceleration" rules, and was not provided in Notice 2005-1.*** **Example:** A change in form from a 10-year installment payment treated as a single payment to a lump sum would not be an acceleration, provided the change complied with the "subsequent change" rules (e.g., the change is not effective for 12 months and lump sum payment not made until at least 5 years after the date the installment payments were scheduled to commence).
Multiple Payment Events	If a plan permits a payment upon two or more permissible distribution events provided in the regulations (e.g., upon the earlier of a fixed date or separation from service) the rules for changing the form or timing of payment apply separately to each payment due upon each distribution event. For example, a change elected by a participant to the form of payment upon separation from service would not impact the participant's distribution election for payments upon a fixed date. ***Note that this is a new and important clarification of the application of the "subsequent change" rules for plans that include multiple payment events, which was not provided in Notice 2005-1.***

Transition Relief for Distribution Elections

The regulations incorporate the transition relief for distribution elections contained in Notice 2005-1 (Q&A 19), which provided a limited opportunity for participants to make new distribution elections for amounts subject to §409A. The regulations generally extended the deadline to utilize this transition relief from December 31, 2005 to December 31, 2006 — a one year extension of the deadline that was initially contained in Notice 2005-1. However, a distribution election cannot be made during this additional one year extension for amounts payable in 2006 or which would become payable in 2006 as a result of a new distribution election.

IV. PERMISSIBLE DISTRIBUTIONS

Overview

§409A generally provides that payments may only be made at certain times or upon certain events specified in the statute (e.g., separation from service, disability, death, a specified time or pursuant to fixed schedule, upon a change in control, and upon an unforeseeable emergency). In addition, the statute provides that a plan may not permit any acceleration of the specified time or fixed schedule for paying benefits, except as provided by Treasury guidance. The regulations incorporate these rules and provide additional guidance on the requirements for a payment to be made in compliance with §409A.

General Requirements for Payments to be Made Upon a Permissible Distribution Event

The regulations include guidance on the general requirements for payments to be considered made upon a permissible distribution event provided in §409A, as summarized below.

GUIDANCE FOR PAYMENTS TO BE CONSIDERED MADE UPON A PERMISSIBLE DISTRIBUTION EVENT

Issue	Provisions in the Regulations
Payment Upon Multiple Distribution Events	Where a plan provides for payment upon two or more permissible distribution events, the plan may provide that payment will be made upon the earlier of, or the later of, the occurrence of such events. A plan may provide that an intervening event that is a permissible distribution event may override an existing schedule already in payment status (e.g., a participant's remaining account may be distributed in a lump sum if the participant dies while receiving installments that commenced upon separation from service).
Plan Must Designate a Payment Date	The regulations generally require that where a payment is based upon the occurrence of a specified event (e.g., separation from service, disability, death, a change in control, and an unforeseeable emergency), the plan must designate either an objectively determinable date, or calendar year following the event, upon which payment will be made. ◆ **Example — Designation of Specific Date for Payment:** A plan may provide that if a participant becomes disabled, the payment date will be 60 days following the date on which the participant becomes disabled. ◆ **Example — Designation of Calendar Year for Payment:** A plan may provide that upon death, the payment date will be the first calendar year following the date of death. If a plan designates the calendar year in which payment will be made (rather than designating the specific payment date) the payment date will be deemed to be January 1st of such calendar year for purposes of applying the "subsequent change" rules of §409A regarding a change in the form or timing of payment.
When a Payment is Treated as Made Upon the Designated Payment Date	A payment will generally be treated as made upon the designated payment date if the payment is made by the later of (i) the first date that it is administratively practicable to make such payment on or after the designated payment date, or (ii) the end of the calendar year containing the designated date (or the end of the calendar year if only a year is designated).

GUIDANCE FOR PAYMENTS TO BE CONSIDERED MADE UPON A PERMISSIBLE DISTRIBUTION EVENT (CONT.)

Issue	Provisions in the Regulations
Plan May Designate a Fixed Schedule For Payment	A plan may also provide that following the occurrence of a permissible distribution event, payment will be made in accordance with a fixed schedule that is objectively determinable as of the date of the event, provided that the schedule must be fixed at the time the permissible payment event is designated, and any change in the fixed schedule will constitute a change in the time and form of payment for purposes of under §409A. **Example:** A plan may provide that an employee will be entitled to three substantially equal annual installment payments commencing as of the first anniversary of the participant's separation from service.
Plan May Designate an Alternative Payment Date or Schedule Based Upon the Date of the Distribution Event	In general, if an arrangement provides that payments will be made upon an objectively determinable date or year, or pursuant to a fixed schedule that is objectively determinable based on the date of the event (as described above), the objectively determined date or fixed schedule must apply consistently regardless of the date on which the specified event occurs. However, an arrangement may allow for an alternative payment schedule if the event occurs on or before one, but not more than one, specified date. As illustrated by the example below, a plan document may maintain a distinction between "retirement" (i.e., separation from service after a specified age) and "termination of employment" (i.e., separation before qualifying for "retirement"). **Example:** The regulations provide that an arrangement may provide that an employee's account balance will automatically be paid in a lump sum if the employee experiences a separation from service prior to age 60, but the employee will receive his or her account balance in 5 annual installment payments if the participant experiences a separation from service on or after the attainment of age 60.

Separation from Service

A plan may allow for payments to be made upon a participant's separation from service (as determined in accordance with the regulations), provided, however, that payments to a "key employee" must be delayed for a period of at least 6 months following the participant's separation from service. The regulations provide guidance on when a participant has experienced a separation from service for purposes of §409A, and the time for identifying who is a "key employee" for purposes of imposing the required 6-month delay, as described more fully below.

GUIDANCE REGARDING PAYMENTS UPON A SEPARATION FROM SERVICE

Issue	Provisions in the Regulations
Separation From Service for Employees	An employee is generally considered to have experienced a separation from service if the employee dies, retires, or otherwise has a termination of employment with the employer. Additional guidance to determine whether or not an employee experiences a separation from service includes: ◆ **Leave of Absence Generally Not a Separation from Service.** A leave of absence (e.g., military leave, sick leave, etc.) is not considered to be a separation from service, unless (i) the period of leave exceeds six months, and (ii) the individual is not provided with a continued right to employment either by statute or contract.

GUIDANCE REGARDING PAYMENTS UPON A SEPARATION FROM SERVICE (CONT.)

Issue	Provisions in the Regulations
Separation From Service for Employees (Cont.)	◆ **Threshold to Determine Whether Performance of Continued Services is Treated as a Separation from Service**. Where an employee will continue to provide services for an employer (as an employee or in some other capacity), the regulations provide that a separation from service will not have occurred for purposes of §409A if the services to be performed are considered "significant" in accordance with the following criteria: ⇨ Continued Services as an Employee (20% Threshold) - Where an employee continues to perform services for an employer as an employee, the services to be performed will be treated as significant (i.e., a separation from services will not have occurred) if (i) the employee continues to provide services at an annual rate that is at least equal to 20% of the average services rendered during the immediately preceding three full calendar years of employment (or, if employed less than three years, such lesser period), and (ii) the annual remuneration for such services is at least equal to 20% of the average annual remuneration eared by the employee during the final three full calendar years of employment (or, if employed less than three years, such lesser period). ⇨ Continued Services in a Capacity Other than as an Employee (50% Threshold) - Where an employee continues to perform services for an employer in a capacity other than as an employee (e.g., as a non-employee consultant), the services to be performed will be treated as significant (i.e., a separation from services will not have occurred) if (i) the former employee continues to provide services at an annual rate that is at least equal to 50% of the average services rendered during the immediately preceding three full calendar years of employment (or, if employed less than three years, such lesser period), and (ii) the annual remuneration for such services is at least equal to 50% of the average annual remuneration eared by the employee during the final three full calendar years of employment (or if less, such lesser period).
Identification of "Key Employees"	**General Rule - Six-Month Delay in Payments Required for "Key Employees."** §409A requires that payments to be made upon the separation from service of a "key employee" (as defined in Internal Revenue Code Section 416(i)) of a public company must be delayed for a period of at least six months following the participant's separation from service (unless the participant dies during the delay – eliminating that requirement). Non-employee directors generally will not be subject to the six-month delay requirement. **Identification of "Key Employees."** The regulations provide that "key employees" are identified based on the 12-month period ending on an identification date (such 12-month period is referred to below as the "identification period"). The identification date will be deemed to be December 31 unless the employer has chosen to designate another identification date. All individuals who are considered to be key employees under Internal Revenue Code Section 416(i)) during the identification period must be treated as key employees for purposes of the plan during the 12-month period that begins on the first day of the 4th month following the close of the identification period. **Example:** If December 31 is the identification date, all individuals identified as key employees for the calendar year ending December 31, 2006 must be treated as key employees for purposes of the plan (and therefore subject to a 6-month delay in payments upon a separation from service) for the period between April 1, 2007 through March 31, 2008. *Note*: The regulations provide that an employer may select an identification date other than December 31, provided that (i) the identification date must be used consistently, and (ii) any change to the identification date cannot be effective for a period of at least 12 months.
Separation From Service for Independent Contractors	An independent contractor is generally considered to have experienced a separated from service upon the expiration of the contract (or in the case of more than one contract, all contracts) under which services are performed for the service recipient.

Disability

§409A allows payments to commence upon a participant's disability; however, it specifically defines the conditions under which a participant may be considered "disabled." The regulations incorporate the definition of disability provided in §409A. The regulations also clarify that a plan may have a more limited definition of disability than the one provided in §409A (i.e., a plan is not required to provide for payment upon all conditions that would constitute a disability under the statute), provided that any disability upon which a payment is made must comply with the requirements of §409A. For purposes of determining whether or not an employee is disabled, a plan may provide that an employee will be deemed to be disabled (i) if the employee is determined to be totally disabled by the Social Security Administration, or (ii) if the employee is determined to be disabled in accordance with the employer's disability insurance program (provided the disability definition in such program complies with the requirements of §409A).

Change in Control

§409A allows for payments to commence upon a change in control, provided that the plan definition of "change in control" for purposes of triggering payments complies with the definition provided by Treasury. Notice 2005-1 provided that payments can be made upon the occurrence of a change in the ownership of the corporation (as defined in Q&A-12 of the Notice), a change in effective control of the corporation (as defined in Q&A-13 of the Notice), or a change in the ownership of a substantial portion of the assets of the corporation (as defined in Q&A-14 of the Notice), collectively referred to in the Notice as "change in control events." The regulations generally incorporate the same definitions of "change in control events" that were contained in Notice 2005-1. The regulations also incorporate the requirement provided in Notice 2005-1 that the occurrence of a change in control event must be objectively determinable.

Payments Upon a Specified Time or Pursuant to a Fixed Schedule

§409A allows for payments to be made upon a specified time or pursuant to a fixed schedule. The regulations provide that an amount is considered to be payable upon a specified time or pursuant to a fixed schedule, if (i) the amount, and (ii) the specific payment date or the calendar year in which payment will be made, are "objectively determinable" at the time of deferral. For purposes of this rule, an amount is considered to be objectively determinable if the amount is either specifically identified, or is able to be determined pursuant to a nondiscretionary formula (e.g., 50% of a participant's account balance). If a plan designates the calendar year in which payment will be made, rather than designating the specific payment date, the specified time or fixed schedule for such payment is deemed to be January 1st for purposes of applying the "subsequent change rules" of §409A regarding a change in the form or timing of payment.

Unforeseeable Emergency

§409A allows for payments to be made upon the occurrence of an unforeseeable emergency, provided the payment is made in compliance with the requirements of the regulations. The regulations provide guidance regarding the circumstances under which a payment may be made upon an unforeseeable emergency, as described more fully below.

GUIDANCE REGARDING PAYMENTS UPON AN UNFORESEEABLE EMERGENCY

Issue	Provisions in the Regulations
Definition of "Unforeseeable Emergency"	The regulations incorporate the definition of "unforeseeable emergency" provided in §409A. Specifically, "unforeseeable emergency" is defined as a severe financial hardship of the service provider or beneficiary resulting from: (i) an illness or accident of the service provider or beneficiary, the service provider's or beneficiary's spouse, or the service provider's or beneficiary's dependent; (ii) the loss of the service provider's or beneficiary's property due to casualty; or (iii) other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the service provider or beneficiary.

GUIDANCE REGARDING PAYMENTS UPON AN UNFORESEEABLE EMERGENCY (CONT.)

Issue	Provisions in the Regulations
Examples of What May Be an Unforeseeable Emergency	The regulations indicate that the following may constitute an "unforeseeable emergency": ◆ The need to rebuild a home as a result of damage not otherwise covered by insurance. ◆ The imminent foreclosure or eviction from the service provider's or beneficiary's primary residence. ◆ The need to pay for medical expenses, including non-refundable deductibles, as well as costs for prescription medication. ◆ The need to pay for funeral expenses of a spouse or a dependent.
Examples of What is NOT an Unforeseeable Emergency	The regulations indicate that the following would not constitute an "unforeseeable emergency": ◆ The payment of college tuition. ◆ The purchase of a home (except as otherwise described above).
Limitations on the Amount of Payment	The regulations provide the following limitations on the amount of payment that may be made upon a an unforeseeable emergency: ◆ A distribution on account of an unforeseeable emergency may <u>not</u> be made to the extent that the emergency is or may be relieved through reimbursement from insurance or otherwise or by liquidation of the participant's assets, to the extent the liquidation would not itself cause severe financial hardship. ◆ Amounts payable due to an unforeseeable emergency must be limited to the amount reasonably necessary to satisfy the emergency need (which may include amounts necessary to pay any Federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution). ◆ A determination of the amount necessary to satisfy the emergency must also take into account any additional compensation that is available to the participant if the plan provides for termination of the participant's deferral election following an unforeseeable emergency (as described below).
Plan May Terminate Deferral Elections	A plan may provide that a participant's deferral election under the plan will be terminated if (i) an employee obtains payment from the plan due to an unforeseeable emergency, or (ii) termination of deferrals is required for the employee to receive a hardship distribution under the employer's 401(k) plan.

Acceleration of Payments

§409A provides that, generally, a plan may not permit any acceleration of the specified time or fixed schedule for paying benefits (the "anti-acceleration rule"), except as provided by Treasury guidance. Notice 2005-1 included several exceptions to the anti-acceleration rule, all of which have been incorporated into the regulations. In addition, the regulations provide for other circumstances upon which a payment may be accelerated without violating the requirements of §409A. Below is a summary of certain exceptions to the anti-acceleration rule contained in the regulations.

CERTAIN EXCEPTIONS TO THE ANTI-ACCELERATION RULE

Issue	Provisions in the Regulations
Payments Upon Income Inclusion Under §409A	A plan may permit the acceleration of the time or schedule of a payment in order to pay any amount that is required to be includable in the income of a participant as a result of the failure of the plan to comply with the requirements of §409A. ***Note that this exception was not contained in Notice 2005-1.***
Payment of Employment Taxes	A plan may permit the acceleration of the time or schedule of a payment in order to pay FICA and other employment taxes, including an amount necessary to pay related income tax on the payment.
De Minimis and Specified Amounts	A plan may provide that a participant's benefit will automatically be paid in a lump sum (notwithstanding the participant's payment election), under the following circumstances: ◆ **De Minimis Cashout (for prior deferrals and/or future deferrals).** A plan may be amended with respect to amounts previously deferred under the plan, as well as amounts to be deferred in the future, to permit the acceleration of the time or schedule of a payment to a participant under the plan, provided (i) the payment accompanies the termination of the entirety of the participant's interest in the plan; (ii) the payment is made on or before the later of (A) December 31 of the calendar year in which the participant's separation from service occurs or (B) the date 2 ½ months after the participant's separation from service from the employer; (iii) the payment is not greater than $10,000, and (iv) the participant is not provided an election with respect to the receipt of the lump sum; or ◆ **Specified Amounts (for future deferrals only).** A plan may provide that if a participant's interest under the plan has a value below an amount specified by the plan at the time amounts become payable under the plan, the participant's entire interest under the plan shall be distributed as a lump sum payment. However, <u>this provision can only apply to amounts deferred after the provision is added to the plan</u>. *Note*: The regulations provide that once the plan feature(s) described above apply to a deferred amount, any change or elimination of such feature is subject to the rules regarding a change in the time and form of payment.
Domestic Relations Order	Benefits may be paid as necessary to satisfy a domestic relations order (as defined in Internal Revenue Code §414(p)(1)(B)).
Plans May Terminate Deferral Elections Following an Unforeseeable Emergency	A plan may provide that a participant's deferral election under the plan will be terminated if (i) an employee obtains payment from the plan due to an unforeseeable emergency, or (ii) termination of deferrals is required for the employee to receive a hardship distribution under the employer's 401(k) plan. ***Note that this exception was not contained in Notice 2005-1.***

CERTAIN EXCEPTIONS TO THE ANTI-ACCELERATION RULE (CONT.)

Issue	Provisions in the Regulations
Payments Upon Plan Termination (in Limited Circumstances)	In general, a plan termination is not a permissible distribution event under §409A (i.e., a provision that allows the employer to terminate the plan and immediately distribute plan benefits is prohibited). However, the regulations do provide the following limited exceptions to this rule: ◆ **Upon a Change in Control.** A plan may provide for employer discretion to terminate the plan and immediately distribute benefits within 30 days before, or 12 months after, a "change in control event" (as defined in the regulations). ◆ **Termination of all Arrangements of the Same Type.** An employer may terminate a plan provided that (i) all arrangements of the same type (i.e., account balance plans, nonaccount balance plans, etc) are terminated with respect to all participants, (ii) no payments, other than those payments that would otherwise have been payable under the terms of the arrangements if the termination had not occurred, are made within 12 months of the termination, (iii) all payments are made within 24 months of the termination of the arrangements, and (iv) the employer does not adopt a new arrangement of the same type that was terminated (i.e., account balance plan, nonaccount balance plan, etc) for a period of 5 years following the date of termination. ◆ **Corporate Dissolution or Bankruptcy.** A plan may provide for plan termination upon a corporate dissolution or with the approval of a bankruptcy court.
Acceleration of Vesting	The waiver or acceleration of a condition that constitutes a substantial risk of forfeiture is not considered to be an impermissible acceleration of payment, provided any payment of such amount is made in accordance with the requirements of §409A.

Delay in Payments Permitted in Limited Circumstances

Notice 2005-1 provided that a plan would not be considered to be operated in good faith compliance with §409A if the employer retained discretion under the plan to delay or extend payments and exercised that discretion. However, the regulations do include limited circumstances in which payments may be delayed without violating §409A, including:

- Payments subject to IRC §162(m) – A plan may provide that a payment will be delayed where the employer reasonably anticipates that the employer's deduction with respect to the payment would be limited/eliminated by application of Internal Revenue Code §162(m). The terms of the arrangement must require the payment to be made either at the earliest date at which the employer reasonably anticipates the deduction would not be limited/eliminated or the calendar year in which the participant separates from service. If a plan is amended to add this provision, the amendment cannot be effective for a period of at least 12 months. In addition, if a plan is amended to remove this provision with respect to amounts deferred prior to the amendment, the amendment will constitute an impermissible acceleration of payment.
- Payments that violate a loan covenant or similar contractual requirement – If a plan contains this provision, the plan must provide that the payment will be made in the first calendar year in which the employer reasonable anticipates that the payment would not violate the loan/contractual terms.
- Payments that would violate Federal securities laws or other applicable law – If a plan contains this provision, the plan must provide that the payment will be made in the first calendar year in which the employer reasonable anticipates that the payment would not result in a violation of Federal securities law or other applicable law.

V. STATUTORY EFFECTIVE DATE AND GRANDFATHERED AMOUNTS

When an Amount is Considered "Deferred" for §409A

The requirements of §409A generally apply to any amounts deferred into a nonqualified deferred compensation plan on or after January 1, 2005. Notice 2005-1 provided initial guidance to determine whether an amount is considered deferred before January 1, 2005. Consistent with that guidance, the regulations provide that an amount is considered deferred before January 1, 2005 if prior to that date (i) the participant had a legally binding right to be paid the amount, and (ii) the right to the amount was earned and vested. The regulations also provide clarification as to when a stock right or similar right to compensation will be treated as earned and vested. The table below summarizes the factors to consider in determining whether an amount is considered deferred before January 1, 2005 (and therefore eligible for "grandfathering").

GUIDANCE TO DETERMINE WHETHER AN AMOUNT WAS DEFERRED BEFORE JANUARY 1, 2005

Issue	Provisions in the Regulations
Legally Binding Right	An amount to which a participant did not have a "legally binding right" before January 1, 2005 will not be considered deferred before January 1, 2005. The regulations indicate that a participant does not have a legally binding right to payment before January 1, 2005 if the employer retains discretion to reduce the amount.
Earned and Vested	An amount that was not "earned and vested" before January 1, 2005 will not be considered deferred before January 1, 2005. Consistent with Notice 2005-1, the regulations provide that a right to an amount is earned and vested only if the amount is not subject to either a substantial risk of forfeiture (as defined in §1.83-3(c)) or a requirement to perform further services. As a result, examples of amounts subject to 409A, include: ◆ **Certain Bonus Payments Earned in 2004** – Bonus earned in 2004 (paid in 2005) is subject to §409A if the employer's bonus program required the participant to be employed on the payment date after December 31, 2004, in order to be eligible to receive the bonus payment. ◆ **Unvested Employer Contributions** – Employer contributions made to a plan on or before December 31, 2004, which were unvested as of December 31, 2004 are subject to §409A. The regulations also provide that stock rights, stock appreciation rights or similar compensation will be treated as earned and vested before January 1, 2005 if the right was either immediately exercisable for cash or substantially vested property before January 1, 2005.

Determination of "Grandfathered" Amounts

Notice 2005-1 provided initial guidance for determining the amounts deferred prior to January 1, 2005 (the "grandfathered" amounts). The regulations generally incorporate the guidance contained in the Notice and provide additional guidance for determining the grandfathered amount in a separation pay plan or window program, as summarized in the table below.

GUIDANCE TO DETERMINE GRANDFATHERED AMOUNTS

Issue	Provisions in the Regulations
Account Balance Plans	Consistent with Notice 2005-1, the regulations provide that for account balance plans (defined by reference to the FICA regulations), such as voluntary deferred compensation plans or defined contribution SERPs (i.e., supplemental executive retirement plans), the grandfathered amount generally will equal the vested account balance as of December 31, 2004, plus any earnings with respect to such amounts.
Nonaccount Balance Plans	Consistent with Notice 2005-1, the regulations provide that for nonaccount balance plans (defined by reference to the FICA regulations), such as defined benefit SERPs, the grandfathered amount is determined as follows: ◆ The present value as of December 31, 2004, of the amount to which the service provider would be entitled under the plan if the service provider voluntarily terminated services without cause on December 31, 2004, and received a payment of the benefits with the maximum value available from the plan on the earliest possible date allowed under the plan to receive a payment of benefits following the termination of services. ◆ The regulations also clarify that grandfathered amounts may increase in subsequent years to equal the present value of the benefit the service provider actually becomes entitled to, determined under the terms of the plan (including applicable limits under the Code), as in effect on October 3, 2004, without regard to any further services rendered by the participant after December 31, 2004, or any other events affecting the amount of or the entitlement to benefits (other than the participant's survival or a participant election under the terms of the plan with respect to the time or form of an available benefit).
Equity Based Compensation	For "equity compensation plans," the grandfathered amount generally will equal the payment that would be available if the right were exercised on December 31, 2004, and any earnings with respect to such amount (including appreciation of the underlying stock after December 31, 2004 and accrual of dividends).
Separation Pay Plans and Window Programs	The preamble to the regulations indicates that the grandfathered amount under such plans is to be calculated by analogy to the principles used to calculate the grandfathered amounts under a nonaccount balance plan or an account balance plan, as applicable, depending on the structure of the separation pay plan or window program.

Material Modification

§409A generally provides that amounts deferred prior to January 1, 2005 will be eligible for grandfathering unless a "material modification" is made after October 3, 2004 with respect to such deferrals. Notice 2005-1 provided initial guidance on the definition of "material modification." The regulations generally incorporate that definition. In particular, the regulations provide that a "material modification" would occur if a benefit or right existing as of October 3, 2004 is materially enhanced or a new benefit or right is added, and the material enhancement or addition affects amounts earned and vested before January 1, 2005. A material modification can occur pursuant to an amendment or merely by the employer's exercise of discretion under the terms of the plan. Furthermore, a material modification may occur even if the added or enhanced benefit would be permitted under §409A. Conversely, the reduction of an existing benefit or right is not a material modification.

The regulations provide additional guidance regarding actions that would be considered a material modification of amounts deferred prior to January 1, 2005, as discussed more fully below.

GUIDANCE ON MATERIAL MODIFICATION

Issue	Provisions in the Regulations
Rescission of a Modification is Permitted ("No Harm, No Foul" Rule)	In response to concerns by commentators that a change in a grandfathered arrangement could inadvertently cause the arrangement to become subject to §409A, the regulations provide that an employer may rescind a modification in limited circumstances (i.e., an employer may take action to undo a modification without the modification being treated as a "material modification" for purposes of §409A), provided that the rescission occurs by the earlier of: (i) the date before any additional right granted by the modification is exercised (if the change grants a discretionary right), or (ii) the last day of the calendar year during which the modification occurred. *Note*: This rescission right does not apply to any modification that is made with the knowledge that the modification would cause the arrangement to become subject to §409A.
Plan Aggregation Rules do Not Apply	The plan aggregation rules of §409A do not apply to material modifications; therefore, a material modification of one arrangement would not necessarily result in the material modification of all other plans of a similar type that are maintained by the plan sponsor (e.g., account balance plans, nonaccount balance plans, etc.).
Examples of What is a Material Modification	The regulations indicate that the following actions would be a "material modification" to amounts that otherwise would be grandfathered: ◆ The addition of a "haircut" provision to an existing plan after October 3, 2004. ◆ The employer's exercise of discretion to accelerate vesting on or prior to December 31, 2004 even if the plan provides for such discretion. ◆ The addition of a hardship provision (i.e., right to payment upon an unforeseeable emergency) ◆ Changing (or adding to) the notional investments available under a plan to include an investment measure that does not qualify as a "predetermined actual investment" (as defined in the FICA regulations).

GUIDANCE ON MATERIAL MODIFICATION (CONT.)

Issue	Provisions in the Regulations
Examples of What is NOT a "Material Modification"	The regulations indicate that the following actions would not be a "material modification" to amounts that otherwise would be grandfathered:" ◆ Changing (or adding to) the notional investments available under a plan to include an investment measure that qualifies as a "predetermined actual investment" (as defined in the FICA regulations) or reflects a reasonable rate of interest for any given taxable year (as defined in the FICA regulations). ***Note: the addition of the reference to reasonable rate of interest provides additional clarity that was not included in Notice 2005-***1. ◆ Establishing or contributing to a trust, including additional contributions to an existing trust, from which benefits are to be paid (provided that the contribution to the trust would not otherwise cause an amount to be includable in the service provider's gross income. ***Note: this is additional clarity that was not included in Notice 2005-1***. ◆ The removal of a "haircut" provision. ◆ Amending an arrangement to comply with §409A. ◆ A cessation of deferrals or termination of a plan under the provisions of a plan. ◆ The exercise of employer discretion over the time and manner of payment to the extent provided under the terms of the plan as of October 3, 2004.

VI. CALCULATION AND TIMING OF INCOME INCLUSION AMOUNTS AND AMOUNTS DEFERRED

Under Notice 2005-1, amounts actually deferred under a nonqualified deferred compensation plan after December 31, 2004 must be reported by plan sponsors. In addition, amounts required to be included in income due to the failure of a plan to comply with the requirements of §409A must be reported by plan sponsors and applicable amounts appropriately withheld. Unfortunately, the regulations did not provide guidance with respect to the calculation of the amount of deferrals or of the amount of income inclusion upon a violation of §409A, although future guidance is expected. Below is a summary of the reporting requirements under §409A.

CALCULATION AND TIMING OF INCOME INCLUSION AMOUNTS AND AMOUNTS DEFERRED

Issue	Provisions in the Regulations
Overview	Generally, §409A requires that plan sponsors report (i) all amounts deferred under a nonqualified deferred compensation plan during the year (plus earnings), and (ii) any amounts includable in the gross income of a participant under §409A, on a Form W-2 (for employees) or on a Form 1099-MISC (for non-employees). The preamble to the regulations indicates that Treasury and the IRS will issue additional guidance relating to these reporting requirements, including methods for calculating both the amount of deferral for a year, and the amount required to be included in gross income under §409A. The preamble to the regulations states that taxpayers may continue to rely on Notice 2005-1, Q&A-24 through Q&A-38, until such further guidance is issued.
Form W-2/Form 1099-MISC Reporting	Employees: The total amount of an employee's deferrals (plus earnings) for the year under a nonqualified deferred compensation plan should be reported in box 12 of Form W-2 using Code Y. In addition, Code Z in box 12 should be used to report amounts included in income under §409A. The amount included in income under §409A should also be included in the amount reported in box 1. *Please refer to the instructions for 2005 Form W-2 (available at* http://www.irs.gov/pub/irs-pdf/iw2w3.pdf *) for additional information relating to the §409A reporting requirements).* Non-Employees: The total amount of a non-employee's deferrals (plus earnings) for the year under a nonqualified deferred compensation plan should be reported in box 15a of Form 1099-MISC. In addition, box 15b of Form 1099-MISC should be used to report amounts included in income under §409A. The amount included in income under §409A should also be included in the amount reported in box 7. *Please refer to the instructions for 2005 Form 1099-MISC (available at* http://www.irs.gov/pub/irs-pdf/i1099msc.pdf*) for additional information relating to the §409A reporting requirements).*
Comments Requested	Treasury and the IRS have requested comments in two areas related to the calculation of the amount included in income and the calculation of the amount deferred under §409A: ◆ Whether and how "negative earnings" may be accounted for in determining the amount of deferrals and the amount of income inclusion for a given taxable year, particularly when continuing violations of §409A extend to successive tax years; and ◆ What transition relief may be appropriate for plan sponsors in calculation of current deferrals and amounts to be included in income in order to meet reporting and withholding obligations.

VII. RELIEF FOR NQDC PLANS LINKED TO QUALIFIED PLAN BENEFITS AND/OR DISTRIBUTION ELECTIONS

Overview

In general, a nonqualified deferred compensation plan (referred to below as a "NQDC plan") that is linked to a qualified plan may violate the terms of §409A if a change in the qualified plan would cause the amount deferred in the NQDC plan to increase (in effect, an untimely deferral election) or cause the amount deferred in the NQDC plan to decrease (essentially, an impermissible acceleration). The regulations provide limited circumstances under which NQDC plans may be linked to qualified plans without violating the timing rules for deferral elections or the anti-acceleration rules of §409A. Furthermore, until December 31, 2006, it is permissible under the regulations for the distribution election under a qualified plan to control the time and form of payment under the NQDC plan. Below is a summary of the provisions in the regulations for NQDC plans linked to qualified plan benefits and distribution elections.

Distribution Elections Linked to Qualified Plans

For periods ending on or before December 31, 2006, the time and form of payment under a NQDC plan may be linked to the distribution election under a qualified plan without violating §409A, provided that the linked distribution election is made pursuant to the terms of the NQDC plan in effect as of October 3, 2004. This is a one year extension of the transition relief provided in Notice 2005-1. However, the preamble to the regulations states that this exception to the general election timing rules under §409A regarding the election of a time and form of payment will not be made permanent.

NQDC Plans Linked to Qualified Plan Benefits

The table below summarizes the relief provided in the regulations for NQDCP plans linked to qualified plan benefits.

SUMMARY OF RELIEF FOR NQDC PLANS LINKED TO QUALIFIED PLAN BENEFITS

Issue	Provisions in the Regulations
How can a NQDC Plan be Permissibly Linked to a Qualified Plan?	If the amount deferred under the terms of the NQDC plan is determined under a qualified plan's benefit formula applied without regard to one or more limitations under the Internal Revenue Code ("Code") or determined as an amount offset by some or all of the benefits provided under a qualified plan, the operation of the qualified plan with respect to changes in benefit limitations under the Code does not constitute: ◆ a deferral election under §409A, even if such operation results in an increase of amounts deferred under the NQDC plan, provided that such operation does not otherwise result in a change in the time or form of payment under the NQDC plan, and ◆ an acceleration of payment under §409A, regardless of whether such operation results in a decrease of amounts deferred under the NQDC plan.

SUMMARY OF RELIEF FOR NQDC PLANS LINKED TO QUALIFIED PLAN BENEFITS (CONT.)

Issue	Provisions in the Regulations
Actions/Inaction in a Qualified Plan that do not result in a Deferral Election or Acceleration of Payment in a NQDC Plan	The following actions or inactions in a qualified plan will not violate the anti-acceleration rules of §409A or the timing rules for deferral elections: ◆ Increase/Decrease in Benefits by Amendment: ⇨ An amendment to freeze or limit future accruals of benefits under the qualified plan (which would increase benefits under the NQDC plan) is not a deferral election, and ⇨ An amendment to increase benefits under the qualified plan (which would decrease benefits under the NQDC plan) is not an acceleration of payment. ◆ Increase/Decrease in Subsidized Benefit or Ancillary Benefit: The addition or removal of a subsidized benefit or ancillary benefit under the qualified plan, or a service provider's action or inaction with respect to an election to receive a subsidized benefit or ancillary benefit under the qualified plan, is not a deferral election or an acceleration of payment.
Actions/Inactions in a §401(k) or Similar Type of Qualified Plan that do not result in a Deferral Election or Acceleration of Payment in a NQDC Plan	◆ Change in Elective Deferral Amounts: The service provider's action or inaction (including an adjustment to a deferral election) under a §401(k) plan or similar plan, is not: ⇨ a deferral election, provided that for any given calendar year, the service provider's actions or inactions must not result in an increase in the amounts deferred under all NQDC plans in which the service provider participates in excess of the §402(g) limit in effect for the year. ⇨ an acceleration of payment under the NQDC plan, provided that for any given calendar year, the service provider's actions or inactions must not result in a decrease in the amounts deferred under all NQDC plans in which the service provider participates in excess of the §402(g) limit in effect for the year. *(Note: The §402(g) limit is $14,000 in 2005 and $15,000 in 2006).* *Note*: An example in the regulations generally approves a traditional §401(k) wrap plan scenario – i.e., a design where amounts are first deferred into the NQDC plan until a determination is made regarding the proper amount to be credited to the §401(k) plan. The transfer of an amount no greater than the §402(g) limit from a NQDC plan to a §401(k) plan as soon as administratively practicable is not considered an acceleration of payment under §409A.

SUMMARY OF RELIEF FOR NQDC PLANS LINKED TO QUALIFIED PLAN BENEFITS (CONT.)

Issue	Provisions in the Regulations
Actions/Inactions in a §401(k) or Similar Type of Qualified Plan that do not result in a Deferral Election or Acceleration of Payment in a NQDC Plan (Cont.)	◆ Change in Matching Contributions or other Contingent Contributions. The service provider's action or inaction under a qualified plan with respect to elective deferrals or after-tax contributions that affects the amounts that are credited under an NQDC plan as matching contributions or other contingent contributions, is not: ⇨ a deferral election, provided that for any given calendar year, the service provider's actions or inactions must not result in an increase in the amounts deferred under all NQDC plans in which the service provider participates in excess of the §402(g) limit in effect for the year. ⇨ an acceleration of payment under the NQDC plan, provided that for any given calendar year, the service provider's actions or inactions must not result in a decrease in the amounts deferred under all NQDC plans in which the service provider participates in excess of the §402(g) limit in effect for the year. Matching contributions or other contingent contributions must be forfeited or never credited to the NQDC plan in the absence of the service provider's elective deferral or after-tax contribution to the qualified plan. *Note*: A matching formula included in a NQDC plan with no offset or link to amounts deferred in the qualified plan (including the matching contribution) should not be impacted by this part of the regulations.

VIII. GUIDANCE ON WHETHER CERTAIN ARRANGEMENTS ARE BEYOND THE SCOPE OF §409A

Overview

The requirements of §409A apply to any amounts deferred into a nonqualified deferred compensation plan on or after January 1, 2005. The term "nonqualified deferred compensation plan" is broadly defined in §409A as any plan or arrangement that provides for the "deferral of compensation" subject to certain limited exceptions. The regulations provide guidance describing which arrangements are excluded from §409A, and address the circumstances under which §409A applies to specific arrangements, such as severance plans, arrangements with independent contractors, certain foreign arrangements, and split-dollar life insurance arrangements.

Short -Term Deferrals

In general, an arrangement that provides for "short-term deferrals" is not subject to §409A. The regulations provide guidance on what is required for an arrangement to fall within this exception, as summarized below.

GUIDANCE ON SHORT-TERM DEFERRALS

Issue	Provisions in the Regulations
"Short-Term Deferrals"	"Short-term deferrals" are generally any amounts paid within 2½ months after the later of the participant's or employer's taxable year in which the amounts become vested. The regulations provide the following additional guidance on this rule: ◆ **Payments Delayed Due to Unforeseeable Events**. A payment made after the 2½ month short-term deferral period may continue to qualify as a short-term deferral if it is established that: (i) it was administratively impracticable to make the payment before the close of such period or that making the payment before the end of such period would have jeopardized the solvency of the plan sponsor; (ii) such impracticability or insolvency was unforeseeable; and (iii) the payment will be made as soon as reasonably practicable. ◆ **Deadline for Payment Not Required to be in Writing.** An arrangement is not required to provide in writing that payment must be made by the short-term deferral deadline in order to qualify for this exception. *Note*: If the payment of an amount is not made by the applicable short-term deferral deadline (i.e., the amount becomes subject to §409A) and the arrangement does not specify the payment date for such amount in writing, the arrangement would be in violation of the requirement of §409A that the payment terms (e.g., the payment date, the permissible distribution events, etc.) must be in writing.

Separation Pay Arrangements

Severance pay arrangements (referred to in the regulations as "separation pay" arrangements) are not categorically excluded from §409A. However, the regulations do provide limited exceptions from §409A for certain types of separation pay arrangements, as described below.

GUIDANCE ON APPLICATION OF §409A TO SEPARATION PAY ARRANGEMENTS

Issue	Provisions in the Regulations
Separation Pay is Generally Subject to §409A	An arrangement that provides for the deferral of compensation upon separation from service is generally subject to §409A, even when the right to payment of the compensation is conditioned upon a separation of service.
Separation Pay Cannot be Used to Avoid §409A	Any payment or benefit that acts as a substitute for, or replacement of, amounts deferred under a nonqualified deferred compensation plan will not be excluded from coverage under §409A and will be treated as a payment of the amounts under the nonqualified deferred compensation plan rather than as payment under the separation pay arrangement. In other words, the separation pay arrangement cannot be used to circumvent the application of §409A.
Distribution Elections For Negotiated Involuntary Separation Pay	An election as to the time and form of payment may be made on or before the date a legally binding right to payment is obtained where the separation pay is due to involuntary termination and is negotiated through a bona fide, arm's length transaction at the time of the separation from service.
Certain Involuntary Separation Pay Arrangements and Window Programs Excluded from §409A	Involuntary separation pay arrangements or window programs (i.e., programs offered for a limited period of time to plan participants who separate from service during a set period, no greater than one year) that provide the following limits as to time and amount of payment are excluded from §409A: ◆ **Amount of Payments** - the amount of payments does not exceed the lesser of: ⇨ two times annual compensation for the preceding calendar year; or ⇨ two times the annual compensation limit under §401(a)(17) *(Note: $210,000 for 2005).* ◆ **Timing of Payments** - the payments are required to be made no later than the end of the second calendar year following the year of separation. *Note*: The regulations do not treat the right to a payment upon a separation from service for "good reason" as a right that is subject to a substantial risk of forfeiture. Treasury and the IRS have requested comments with respect to such arrangements.

GUIDANCE ON APPLICATION OF §409A TO SEPARATION PAY ARRANGEMENTS (CONT.)

Issue	Provisions in the Regulations
Other Forms of Separation Pay Excluded from §409A	The following forms of separation pay are also excluded from §409A: ◆ **De Minimis Payments.** Payments of separation pay not exceeding $5,000 in the aggregate. ◆ **Reimbursements.** Reimbursement for reasonable business expenses, outplacement expenses and moving expenses directly related to the termination of services may be provided for a limited period of time. ◆ **In-Kind Benefits and Direct Payments.** Entitlement to certain in-kind benefits from the plan sponsor or certain payments by the plan sponsor directly to a provider may be provided for a limited period of time. ◆ **Collectively Bargained Separation Pay Arrangements.**

Arrangements with Independent Contractors

The regulations provide guidance on the application of §409A to arrangements between a plan sponsor and an unrelated independent contractor, as described below.

GUIDANCE ON APPLICATION OF §409A TO ARRANGEMENTS WITH INDEPENDENT CONTRACTORS

Issue	Provisions in the Regulations
Independent Contractors	Arrangements between a plan sponsor and an unrelated independent contractor (other than a director or provider of management services) are excluded from coverage under §409A if the independent contractor provides "significant services" to two or more unrelated service recipients during the taxable year of the deferral. "Significant service" is provided to two or more service recipients if not more than 70% of the total annual revenue generated is derived from any particular employer or group of related employers. Additional guidance provided in the regulations includes the following: ◆ **Director Services.** Directors are not excluded from coverage under §409A. The regulations provide the following guidance on the application of §409A to arrangements that include a director who provides services as a director to two or more unrelated service recipients: ⇨ The plan aggregation rules do not apply (i.e., the provisions of §409A apply separately to arrangements between the director and each service recipient – and failures with respect to one arrangement will not impact arrangements with unrelated service recipients for the director). ⇨ An arrangement for an employee director will be treated as an arrangement for services as a director only to the extent that another non-employee director defers compensation under the same, or a substantially similar, arrangement or similar terms. ◆ **Management Services.** Where an independent contractor is providing "management services" (as defined in the regulations), such services are not considered unrelated and is therefore subject to coverage under §409A.

Foreign Arrangements

The regulations provide guidance on the application of §409A to foreign arrangements, as described below.

GUIDANCE ON APPLICATION OF §409A TO CERTAIN FOREIGN ARRANGEMENTS

Issue	Provisions in the Regulations
Foreign Arrangements	Certain foreign arrangements are excluded from coverage under §409A, including: ◆ Amounts paid under a tax treaty which are excludable from income for Federal income tax purposes; ◆ De minimis contributions under a foreign nonqualified deferred compensation plan for a calendar year in which the service provider is a nonresident alien in the U.S. and the amount deferred does not exceed $10,000; ◆ Amounts deferred up to the maximum foreign earned income exclusion under IRC §911 by U.S. citizens or resident aliens working abroad and participating in an arrangement where deferrals would otherwise constitute foreign earned income; ◆ Nonelective deferrals of foreign earned income in a broad-based foreign retirement plan for U.S. citizens or resident aliens working abroad not eligible to participate in a qualified plan, provided that the amount deferred in a given year does not exceed the qualified plan limits under IRC §415; ◆ Amounts paid under totalization agreements entered into between the U.S. and any foreign jurisdiction; and ◆ Amounts paid under tax equalization agreements, provided that payment under the agreement is made no later than the end of the 2nd calendar year beginning after the year in which the U.S. individual tax return is filed.

Stock Options and Stock Appreciation Rights

The regulations generally provide that stock options and stock appreciation rights (SARs) for employer stock issued at an exercise price at least equal to fair market value on the date of grant are excluded from coverage under §409A. However, note that if the stock right contains a feature for deferral of compensation, the stock right will be subject to §409A, as described below.

GUIDANCE ON APPLICATION OF §409A TO STOCK OPTIONS AND STOCK APPRECIATION RIGHTS (SARS)

Issue	Provisions in the Regulations
Stock options and SARs; Generally	Stock options and SARs on employer stock are excluded from coverage under §409A where: ◆ the exercise price is not less than the fair market value of the underlying equity on the date of grant; ◆ the number of shares subject to the arrangement is fixed at the date of grant; ◆ the arrangement does not include any feature for the deferral of compensation, other than: ⇨ For stock options, income may not be deferred beyond the later of the exercise or disposition of the option or the time the stock acquired pursuant to the option first becomes substantially vested. ⇨ For SARs, income may not be deferred beyond the exercise of the SAR; and ◆ The underlying stock must relate to "service recipient stock" (generally common stock of the employer, which may include ADRs). *Note*: The ability to defer compensation under a stock option or a SAR constitutes an "additional deferral feature" which may impact whether the underlying equity program is subject to the requirements of §409A. For example, a stock right with a deferral feature is subject to §409A from the date of grant. As a result, to comply with §409A, the stock right would be required to specify a permissible payment time and a form of payment, which would significantly change the nature of these arrangements. Where a deferral feature is added to an existing stock option or SAR, the stock right generally would violate §409A because it would be subject to the requirements of §409A from the date of grant but would have failed to specify a permissible payment time or event.
SARs for Privately Held Employers	Notice 2005-1 provided a limited exception for SARs issued with respect to employer stock, readily tradable on an established securities market, and which was required to be settled in such employer stock. The regulations expand the exception for SARs granted with respect to stock of privately held employers, provided that the valuation of the underlying stock is performed in accordance with the regulations discussed above. The regulations also were expanded so that SARs of a public or private employer may be settled in cash or stock.
Treatment of Dividend Rights	Rights to dividends declared and paid between the date of grant and the date of exercise may be subject to §409A. The plan sponsor may provide such dividend rights in a separate agreement in order to prevent the stock right related to the dividend rights from being subject to §409A.
Modification of a Stock Right	Any modification of a stock right is generally treated as a new grant that may affect its exclusion from §409A. The regulations allow limited exceptions from §409A for modifications, including certain extensions of the exercise period upon a termination of employment.

Split-Dollar Life Insurance Arrangements

The regulations do not expressly address the application of §409A to split-dollar life insurance arrangements. However, the preamble to the regulations discuss limited exceptions from §409A for split-dollar life insurance arrangements, as described below. The Treasury and the IRS have requested comments regarding the impact of compliance with §409A for arrangements grandfathered under the split-dollar regulations.

SPLIT-DOLLAR LIFE INSURANCE ARRANGEMENTS

Issue	Provisions in the Regulations
Arrangements Providing Death Benefit Coverage Only Not Subject to §409A	Any split-dollar life insurance arrangement that provides only death benefit coverage to or for the benefit of a service provider will not be treated as a deferral of compensation under §409A pursuant to the general exception from §409A for death benefit plans.
Collateral Assignment Arrangements Treated as a Loan Not Subject to §409A	A collateral assignment split-dollar life insurance arrangement treated as a loan arrangement under Treas. Reg. §1.7872-15 will not give rise to a deferral of compensation under §409A, provided that there is (i) no agreement under which the plan sponsor will forgive the related indebtedness and (ii) no obligation on the part of the plan sponsor to continue to make premium payments without charging the service provider a market interest rate on the funds advanced.
Certain Endorsement Arrangements Are Subject to §409A	An endorsement split-dollar life insurance arrangement (i.e., where the policy is owned by the plan sponsor and the service provider's beneficiary shares in a portion of the death proceeds) will be treated as deferred compensation subject to §409A if the plan sponsor grants the service provider a legally binding right to compensation in a taxable year after a substantial risk of forfeiture lapses. For example, where the arrangement includes an irrevocable promise by the plan sponsor to pay future premiums after the participant vests in/receives the policy pursuant to a §83 transfer of the policy, the arrangement may be subject to §409A.
Material Modifications to Arrangements Grandfathered under the Split Dollar Regulations	To the extent that actions are taken to comply with §409A for a split-dollar life insurance arrangement, plan sponsors have concerns that a grandfathered arrangement entered into on or before September 17, 2003 may be materially modified and treated as a new arrangement subject to the requirements under Treas. Reg. §1.61-22(j)(2)--the split-dollar regulations. In the preamble to the §409A regulations, Treasury and the IRS request comments as to the scope of changes that may be necessary to comply with, or avoid application of §409A, and under what conditions those changes should not be treated as material modifications for purposes of Treas. Reg. §1.61-22(j)(2).