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# Final 409A Regulations

NASPP Webcast

The IRS and Treasury Speak: A Mid-Year Update

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April 12, 2007

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# What is Nonqualified Deferred Compensation?

# What is Deferred Compensation?

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- Overall structure remains the same: General definition with specific exceptions
- No new exceptions, but many specific changes
- Death and disability benefits defined by reference to 3121(v) regulations
- Amounts that are not includible in income are not deferred compensation
- No ability to substitute deferred compensation for non-deferred compensation

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# Equity Rights: Definition of Service Recipient Stock

# Service Recipient Stock

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- General anti-abuse rule added
- Major change to definition regarding permissible class of stock
  - Any class of common stock may be used, regardless of if publicly traded, aggregate outstanding value, transferability restrictions or buyback rights
  - Dividend preferences prohibited
  - Liquidation preference permissible
  - Expect future guidance on other preference items
- General requirement that stock must qualify as common stock under section 305 and may not resemble deferred compensation

# Service Recipient Stock

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- Major change to definition regarding permissible issuers of stock rights
  - Controlling interest ownership threshold lowered from 80% to 50%
    - No formal election required
    - May be determined on a grant by grant basis
  - Retained 20% rule if there are legitimate business criteria, based on facts and circumstances
    - Is there sufficient nexus between service provider and entity for the grant to serve a legitimate non-tax business purpose?

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# Equity Rights: Stock Right Valuation

# Private Company Valuation

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- Rejected requests for a good faith standard like the one applicable to ISOS
- Consistency of valuation method *not* required
- Independent appraisal *not* required
- Can consider any recent equity sales made in an arm's length transaction
- Safe harbors generally retained from proposed regs
- Illiquid stock of start-up rules tweaked
  - Reasonably anticipate at the time of grant that the co will not undergo a CIC in next 90 days or an IPO in next 180 days

# Public Company Valuation

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- If average fmV will be used, irrevocable commitment to grant the right must be made before the beginning of the specified period
  - Designate the recipient of the right
  - Number of shares
  - Method for determining exercise price, including period over which averaging will occur
- Foreign country (i.e., France) requirements for determining exercise price will be respected as long as averaging period does not exceed 30 days

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Equity Rights:  
Modification and  
Assumption of Stock  
Rights

# Extension of Options

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- Permissible to extend exercise period until the earlier of ten years from the date of grant or the end of the original maximum term of the option
- Extension of underwater option permitted

# Substitution of Stock Right

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- Adopt proposed regs provision regarding substitution or assumption of stock right due to a corporate transaction (generally the ISO rules)
- Option holder is not required to be employed by the successor entity, treated as a continuation of the initial option

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# Other Stock Rights Provisions

# Other Stock Right Provisions

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- Payment of accumulated dividends upon option exercise is treated as a reduction in exercise price
- Payment of accumulated dividends treated as separate 409A plan not tied to option exercise is permissible
- Tandem agreements under which exercise of one right cancels the other is permissible (e.g. tandem options/SAR)
- Existing provision permitting option gain deferral, even if not used, is an additional deferral feature and right must comply with 409A
- Any deferral feature added to a right is treated as an deferral feature at the time of grant and a violation of 409A

# Definition of Date of Grant

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- Not addressed in previous guidance
- Refers to the date when the necessary corporate action is taken to create a legally binding right
  - Maximum number of shares and minimum exercise price are fixed or determinable
  - Class of underlying stock identified
  - Identity of recipient designated
- Any unreasonable delay in notifying employees may be an indication that the grant date is not the date corporate action is complete

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# Short-Term Deferral Exception

# Short-Term Deferral

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- Generally retains the rules in the proposed regulations
- Reimbursements don't automatically fit ST deferral based on the "risk" that the employer may not reimburse
- ST deferral is applied based on designation of payments (single payment or a series)
- Underscores the lack of an "operational" short-term deferral if the document provides for NQDC
- Impermissible to bifurcate final accrual in SERP plan if paid within ST deferral to avoid 6 month delay

# Short-Term Deferral

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- Relaxed rules on when payments can be delayed due to unforeseeable events
- New standard:
  - Payment would be administratively impracticable due to unforeseeable circumstances
  - Payment would jeopardize the company's ability to continue as a going concern
  - Because of limitations of 162m

# Short-Term Deferral

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- If an arrangement misses ST deferral, it may comply with 409A if it was not possible for payment to be made in one or more taxable years
  - “2008 bonus will be paid no later than 3/15/2009”  
If bonus can be paid in late December of 2008 or early 2009, payment must be made no later than 3/15/2009.
  - If plan specifies that “2008 bonus will be paid between 1/1/2009 and 3/15/2009”, payment can be made as late as 12/31/2009.

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# Substantial Risk of Forfeiture

# Substantial Risk of Forfeiture

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- Final regulations follow the proposed regulations
- If a right to an amount is subject to 2 or more conditions that independently would be a SRF, the SRF continues until all conditions have been met
- A payment conditioned on an involuntary separation from service without cause as subject to a SRF if there is a substantial risk that the service provider will not be involuntarily separated from service without cause
- The right to a payment on separation from service for good reason may, in certain circumstances, be treated as a right to a payment on involuntary separation from service

# Vested and Nonvested Rights

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- An amount is not considered subject to an SRF after the date or time the recipient could have elected to receive the compensation unless the present value of the amount is materially greater than the present value of the vested amount the recipient could have elected to receive
- Regulations clarify that compensation the service provider would receive for continuing to perform services regardless of whether the provider elected to receive the vested payment is not taken into account to determine whether the present value of the right to the nonvested payment is materially greater.

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# Separation Pay Arrangements

# General Rules

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- Final regulations clarify that:
  - Separation pay means compensation conditioned on separation from service; not amounts that would also be paid on other events e.g., amount payable on change in control, unforeseeable emergency, or on date certain

# General Rules

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- If service provider would forfeit payment upon separation from service, but a payment is made on a voluntary separation from service anyway, the presumption is that vesting was accelerated and payment was subject to section 409A
  - Rebut by showing payment would have been made anyway based on factors:
    - Amount materially less than present value of pro rata forfeited amount
    - Payment customarily made on separation from service by service providers who don't forfeit nonvested deferred compensation rights (e.g., unused leave, release of claims)

# Involuntary Separation/Window Program

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- If exception would apply but amounts exceed limit (lesser of 2 X compensation up to section 401(a)(17) limit), *only the excess* is subject to section 409A
- Final regulations clarify that:
  - The 401(a)(17) limit applicable for the year of separation from service applies
  - Annual rate of pay is determined based on taxable year immediately preceding taxable year in which separation from service occurs, adjusted for increases during the year expected to continue indefinitely if no separation from service

# Definition of Involuntary Separation

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- Facts and circumstances
- Good reason safe harbor
  - Separation from service must occur within two years following the existence of
    - A material diminution in base compensation
    - A material diminution in authority, duties, or responsibilities or the authority, duties, or responsibilities of the supervisor to whom the employee reports;
    - A material diminution in budget;
    - A material change in the geographic location at which services must be performed; or
    - A material breach of the employment agreement Amount, time and form of payment must equal payment upon an involuntary separation from service
  - Plan must include provisions requiring employee notice and employer opportunity to cure

# Reimbursements and Fringe Benefits

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- Fringe benefits excludable from income are not treated as section 409A deferred compensation
- Extended taxable reimbursements of medical expenses to period of COBRA coverage
- Exception for outplacement/moving expenses for a limited time applies to qualifying reimbursements during that time even if the plan extends beyond it
  - Extend the limited time to three years after separation from service for expenses incurred by the service provider (still two years for in-kind benefits)
  - Clarify that reasonable moving expenses include the loss incurred due to sale of a primary residence

# Limited Payments of Separation Pay

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- The final regulations link the maximum exclusion to the 402(g) limit for the year of separation from service to reflect cost-of-living increases

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# Foreign Plans

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# Foreign Plans

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- The rules generally follow the proposed regulations
- Some changes to expand exclusions, in particular for nonUS residents
- Tax equalization payments – time for payment extended so it relates to the time of filing for US returns or foreign returns (or if no return, when the tax is payable)

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# Application to Split Dollar Insurance Arrangements

# Grandfathered and Nongrandfathered Benefits

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- Notice 2007-34
- Method for allocating grandfathered and nongrandfathered benefits
- Loan regime is not a 409A deferred compensation arrangement
- Necessary modifications for 409A do not ungrandfather for split dollar purposes

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# “Plan” and Plan Aggregation Rules

# Plan Aggregation Rules

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- Account balance plans
  - Elective
  - Nonelective
- Non account balance plans
- Separation pay plans
- Other deferred compensation arrangements
- Split-dollar arrangements
- In-kind benefit and reimbursement plans
- Stock rights subject to section 409A
- Foreign plans
- Bifurcation rules of 31.3121(v)(2)-1(c)(1)(iii)(B) must be applied

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# Written Plan Requirement

# Written Plan Requirement

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- Written plan is required for any arrangement other than short-term deferral (and are advisable for short term deferral plans)
- “Plan” can consist of more than one document
- A plan is established on the later of the date adopted, effective, or date material terms are set forth in writing

# Written Plan Requirement

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- Material terms must be in writing including
  - The amount (or method or formula) of deferred compensation provided under the plan
  - Payment schedule or payment triggering events
- 6-month delay rule must be in writing no later than the time the 6-month rule may be applicable to a separation of service of the specified employee
- For deferral elections (initial or subsequent), the plan must specify no later than the time by which the election is required to be irrevocable the conditions under which the election may be made
- Generally, for permitted accelerations, the plan does not have to specify the conditions under which the accelerated payment will be made

# Written Plan Requirement: Savings Clause

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- Regulations provide that “general provisions of the plan that purport to nullify noncompliant plan terms, or to supply any [required] specific plan terms . . . are disregarded.”
- Premium on drafting
- Best practice is to include language of interpretation/consistency with 409A

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# Initial Deferrals

# Initial Elections

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- Final regulations generally follow the proposed regulations
- Service recipient must set the time and form of payment applying the rules for service provider deferrals
- Initial deferral elections:
  - Elections with respect to discretionary bonuses must be made in accordance with general rules
- Elections in first year of eligibility
  - Applicable if service provider has not been an active participant for at least 24 months

# Initial Elections

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- Nonelective excess benefit plans, a service provider is treated as initially eligible to participate as of the first day of the taxable year immediately following the first year the service provider accrues a benefit under the plan (may be used only once)
- Rights are “forfeitable” even if the right may vest earlier than 12 months following the election due to the death, disability, or change in control event

# Performance Based Compensation

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- Allows bifurcation: A portion of an award may be performance-based even if there is another portion that is not, if amounts are separately designated (or identifiable under the plan terms) and determined
- May include certain amounts paid on death, disability, or change in control
- Compensation may be based on subjective performance criteria

# Equity Based Compensation

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- Performance-based compensation generally includes equity compensation based solely on the increase in value of the service recipient or the service recipient's stock after the date of grant
- Phantom units/RSUs -- the right to the compensation must be to a performance-based vesting requirement

# Performance Based Compensation

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- Election can be made as late as 6 months before the end of the performance period, provided
  - Services are provided continuously from the later of the beginning of the performance period or the date the performance criteria are established through the date an election is made, and
  - The compensation is not readily ascertainable
- An amount is readily ascertainable
  - Once it is substantially certain that a goal will be met
  - If amount varies based on the level of performance, an amount is readily ascertainable to the extent the amount is calculable and the goal is substantially certain to be met

# Separation From Service

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- For an involuntary or voluntary separation from service, where there is no right to pay and where separation pay is the subject of bona fide, arm's length negotiations, initial deferral may be made any time before there is a legally binding right to the payment
- Rule does not apply to previously existing legally binding rights to deferred compensation including rights subject to a substantial risk of forfeiture

# Recurring Part-Year Compensation

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- Addresses situations for teachers and others who are paid on an annual basis in a way that can shift amounts between years
- Allows an election to defer compensation at any time before the service period begins provided no amount is deferred after the last day of the 13<sup>th</sup> month following the first day of the performance period

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# Separation from Service

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# Separation from Service

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- Presumed separated if expected that no further services will be provided or that level of service will not exceed 20% of average service over preceding 36 months
- Presumed not separated if expected level of service will exceed 50%
- No presumption between 20% - 50%
- Leave of absence disregarded if expected service provider will return
- Flexibility to use same desk rule to determine separation from service due to CIC if specified no later than closing date of transaction

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# Specified Employees

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# Identification of Specified Employees

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- Section 415 compensation
  - General rule for determining key employees is based on general Reg. § 1.415-2(a) compensation as if not using any safe harbors or special timing rules
    - Note: General rule includes NRA compensation
- May use any available definition of 415 compensation if used consistently for all employees to identify specified employees (regardless of definition used for qualified plans)
- Once a list of specified employees is effective, service recipient can't change the definition of compensation

# Alternative Methods for Six-Month Delay

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- Plan may use alternative method for identifying specified employees if it:
  - Is reasonably designed to include all specified employees
  - Is an objectively determinable standard providing no direct/indirect election to any service provider regarding its application
  - Results in no more than 200 service providers being identified as of any date
- Such delays are not treated as changes in time and form of payment even if service provider is not a specified employee

# Effective Date Issues

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- Proposed regulations said employees identified on identification date become specified employees on first day of the fourth month thereafter
- Final regulations allow service providers to use an earlier date, but any change to effective date cannot become effective for 12 months
- Final regulations clarify that the six-month delay applies only if service provider is a specified employee upon separation from service (even if would have become one if hadn't separated)

# Specified Employees and Transactions

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- Rules for specific situations
  - Public-Public M&A
  - Public-Private M&A
  - Spinoffs (one public into two)
  - IPOs
- In each case
  - Guidance on next identification date
  - Guidance on method for identifying employees in the meantime
  - No more than 50 specified employees at any time

# Application of Six-Month Delay Rule

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- If payment is on account of separate from service is subject to six-month delay, then no acceleration permitted if disability, change in control, or unforeseeable emergency occurs within six months
- But if payment is on account of disability, change in control, or unforeseeable emergency, then six-month delay does not apply even if separate from service
- Can accelerate payments during the six-month delay to pay DROs, ethics law violations, or employment taxes

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# Change in Control

# Change in Control

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- Rules are largely the same
- IPO is not a change in control event (or a permissible acceleration)
- Change in effective control: 30% (reduced from 35%); still not to 280G 20%
- For non-corporate transactions – continue to apply the rules by analogy
- Also – some ability to change pre-existing substantial risk of forfeiture conditions

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# Plan Termination

# Plan Terminations: Change in Control

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- Service recipient can retain discretion to terminate in connection with a change in control
- Termination must be no more than 30 days before and no more than 12 months after the change
- All distributions must be complete within 12 months of the termination (not the change)
- Consistency requirements
  - All plans that would be aggregated and are sponsored by the same service recipient AFTER the change in control
  - Terminate/distribute for all service providers who experienced the change in control
- Related guidance – changes in distribution rules related to “separation from service” in change in control

# Plan Terminations

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- General Termination rules
  - Restriction on new plans is reduced from 5 years to 3
  - Termination that is proximate to a down turn in financial health is not permissible (see exception for dissolution/bankruptcy)
- Terminations in connection with dissolution of corporation or with the approval of the bankruptcy court are permissible

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# Linked Plans

# Linked Qualified and Nonqualified Plans

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- Transition relief (through December 31, 2007) not extended
  - Distributions may be coordinated with qualified plan distributions if part of the plan on October 3, 2004
- Clarifies that elective deferrals and matching contribution 402(g)-based limits are separate additive limits (increased by the catch-up contribution limit)
- Clarifies that qualified plan elections cannot be used as a way to change nonqualified elections
- Some additional relief on contributions contingent on after-tax contributions to qualified plans

# Other Rules

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- Linked cafeteria and nonqualified plans
  - Final regulations provide relief from deferral election timing and anti-acceleration rules where cafeteria plan elections change eligible compensation
- Additional guidance on offsets

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# Distributions and “Payment”

# Distributions and “Payment”

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- “Payment” is defined in the plan: Can be each single payment in a schedule or the stream of scheduled payments
- Distinction is important for
  - Application of redeferral rules
  - Short term deferral and 6 month delay
- Service providers and recipients may use redeferral rules to change time and form of payment

# Distributions and “Payment”

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- Actuarial equivalent life annuities are one form of payment (allows “late” election between forms)
- The following features are disregarded in determining whether a payment is a life annuity
  - Term certain
  - “Pop up” features
  - Cash refund features
  - SS leveling
  - Cost of living indices

# Distributions and “Payment”

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- Actuarial equivalent life annuities
  - Subsidized joint and survivor annuities are equivalent if neither the annual benefit for the service provider or the beneficiary is greater than the annual benefit under the single life annuity
  - E.g., a J&S with a \$100 monthly benefit to the service provider and a \$100 monthly benefit to the survivor is equivalent to a single life annuity providing a \$100 monthly benefit

# Redeferral

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- Addition of death, disability, unforeseeable emergency as an EARLIER payment event is a permissible acceleration
- Redeferral provisions apply to the addition of a specified date or fixed schedule, change in control event, separation from service

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# Key Points For Transition

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- Final regulations are effective January 1, 2008
- Until December 31, 2007, existing standard applies
  - Good faith compliance with statute and Notice 2005-1
  - Compliance with proposed or final regulations is good faith compliance
  - Plans need to comply with Notice 2006-79: form compliance by the end of '07, no “in and out” violations

# Key Points for Transition

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- The form of the plan is required to be in compliance for periods on and after January 1, 2008
- Amendments are NOT required to retroactively bring the plan into compliance or document all operational compliance
- **HOWEVER**, taxpayers must be able to substantiate compliance with 409A during transition
  - Memos to file, elections, agreements can satisfy this requirement

# Key Points for Transition

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- Transition from Good Faith compliance to final regulations
- Stock rights:
  - Granted prior to publication of final regs, and comply with notice or proposed regs, but not final regs, can continue to operate in due course
  - Applies to wrong class of stock, not discounted options
  - Good faith attempt standard continues in effect for setting exercise price (Notice 2006-4)
  - Extensions generally in compliance

# Key Points for Transition

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- Initial deferral elections, elections with respect to performance-based compensation
  - Continue to be effective and in compliance if in compliance with statute or guidance
- Timing and form of payment DOES need to come into compliance, even if agreed upon during the transition period

# Key Points for Transition

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- Separation from Service
  - If in pay status, can continue or revise
  - If separated but not in pay status, commence by the end of 2007
- Good faith position with respect to application of 6-motnh delay will be respected

# Key Points for Transition

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- Material modification: Clarification that a change to a stock right that wouldn't be a modification under 409A isn't a material modification
- Open issue – what happens if a plan is materially modified outside of transition?
- Tweaks to grandfathering – deferral of vested bonus credited in '05 is grandfathered

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# Future Guidance Expected

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# Future Guidance

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- Amount and timing of income inclusion
- Transfers of partnership interests
- Offshore funding
- Income inclusion and 402(b) plans
- Specific points in regs with placeholders for future guidance