K&LNG Alert

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Compensation & Benefits

Proposed Section 409A Regulation: What is Nonqualified Deferred Compensation Under Section 409A?

This is the first in a series of four Alerts that provide a detailed summary of the Proposed Regulations issued on September 29, 2005 by the Internal Revenue Service under Section 409A of the Internal Revenue Code. Section 409A, enacted by the American Jobs Creation Act of 2004, imposes substantial new rules on nonqualified deferred compensation arrangements.

This Alert focuses on the provisions of the Proposed Regulations that relate to the definition of "nonqualified deferred compensation plan" and the determination of which arrangements are subject to Section 409A. We published a general summary of the Proposed Regulations on October 4, 2005. You can access a copy of that Alert here: **http://www.klng.com/files/tbl_s48News/PDFUpload307/12001/CB1005.pdf.**

In the near future, we will publish three additional Alerts that summarize the provisions of the Proposed Regulations that relate to (i) deferral elections, (ii) payment elections and payment triggers and (iii) effective dates, grandfathering issues and transition relief.

TYPES OF PLANS AND ARRANGEMENTS COVERED BY SECTION 409A

Defining the Term "Plan" for Purposes of Section 409A

Section 409A generally applies to all amounts deferred under nonqualified deferred compensation plans. For this purpose, the term "nonqualified deferred compensation plan" includes any arrangement, whether applicable to one person or a group of individuals, that provides for the deferral of compensation. Certain types of plans, however, are excluded from the applicability of Section 409A, including qualified retirement plans, tax-deferred annuities, simplified employee pensions (SEPs), SIMPLEs and certain welfare benefit plans.

Section 457 Plans

Section 409A does not apply to deferred compensation plans sponsored by state or local governments or tax-exempt employers that qualify for tax-favored treatment under Internal Revenue Code Section 457(b). Deferred compensation plans of state or local governments or tax-exempt employers to which Internal Revenue Code Section 457(f) applies (*i.e.*, plans that do not meet the Section 457(b) requirements) are, however, subject to Section 409A separately and in addition to the requirements of Section 457(f). Any amount included in gross income under either Section 409A or Section 457(f) will not later be required to be included in gross income under any other Internal Revenue Code provision. The Proposed Regulations under Section 409A may not be relied upon when applying Section 457(f) to a plan.

Arrangements with Independent Contractors

The Proposed Regulations use the terms "service recipient" and "service provider" in describing the parties to deferred compensation plans. In general, "service recipients" are employers and "service providers" are employees, but Section 409A also

applies to independent contractors who provide services to others, with certain exceptions specified below.[1]

Accrual Basis Taxpayers

Accrual method taxpayers generally report income when earned rather than when paid. Such taxpayers do not generally receive a tax benefit from deferring payment of compensation. Accordingly, the Proposed Regulations provide that Section 409A does not apply to independent contractors who use the accrual method of accounting for tax purposes.

Significant Services to Multiple Recipients

The Proposed Regulations state that Section 409A does not apply to an independent contractor who provides significant services to more than one service recipient. This exception applies if during the tax year in which compensation is deferred the independent contractor provides "significant services" to two or more service recipients that are unrelated to each other and to the service recipient. This analysis must be applied separately to each trade or business in which the independent contractor is engaged. There is a safe harbor test for purposes of determining whether an independent contractor provides "significant services" to multiple unrelated service recipients. The safe harbor test is met, and Section 409A will be inapplicable for a particular taxable year, if not more than 70% of the total revenue of the independent contractor generated by the trade or business for that year is derived from any single service recipient or related group of service recipients, but only if the independent contractor is unrelated to the service recipient.

Corporate Directors Not Excluded

The above exclusion for significant services to multiple service recipients is not applicable to corporate directors who serve on multiple boards. However, if a person serves as a director of more than one unrelated company, the provisions of Section 409A apply separately to arrangements between the director and each separate company. If a participant is both a director and an employee of a service recipient, Section 409A generally applies separately to each relationship. However, this separate treatment will apply to compensation as a director only to the extent that a nonemployee director of the same company defers compensation under a substantially similar arrangement on similar terms. If a person serves both as a director and as an independent contractor for the same service recipient, both arrangements are treated as services provided as an independent contractor.

Providers of Management Services Not Excluded

The Proposed Regulations reflect a concern that where an independent contractor is managing the service recipient, there is a significant potential for the independent contractor to have undue influence or control over compensation matters so that a broad exclusion from coverage under Section 409A is not appropriate. Therefore, the exclusion for independent contractors who serve multiple, unrelated service recipients is not applicable where the independent contractor is providing "management services." In addition, a provider of management services and the service recipient are treated as related for purposes of determining whether arrangements with other service providers qualify for the exclusion. For this purpose, "management services" are (i) services involving actual or de facto direction or control of financial or operational aspects of the service recipient's trade or business or (ii) investment advisory services that are integral to the trade or business of a service recipient whose primary trade or business involves management of investments in other entities (such as a hedge fund or real estate investment trust).

DEFINITION OF NONQUALIFIED DEFERRED COMPENSATION

Legally Binding Right to Compensation

An arrangement is subject to Section 409A only if the participant has a legally binding right to compensation that is not currently includable in the participant's taxable income. A legally binding right to compensation may exist even where the right is subject to a substantial risk of forfeiture (*i.e.*, not vested) or other conditions. What constitutes a "substantial risk of forfeiture" is discussed in the next section. Under the Proposed Regulations, a

[1] Because the terms "service provider" and "service recipient" are somewhat cumbersome and because most deferred compensation arrangements arise in the employment context, for convenience of reference, this Alert generally refers to service providers as "employees" or "participants" and to service recipients as "employers," except where a more precise reference is appropriate.

participant does not have a legally binding right to compensation if the employer or some other person has meaningful negative discretion over the payment of the compensation. "Negative discretion" is the ability to unilaterally reduce or eliminate the compensation after the services have been performed. For example, a bonus arrangement with a target bonus formula under which the employer has the right to determine that a smaller bonus or no bonus will be paid regardless of the target bonus calculation is generally not a deferred compensation plan unless and until the employer actually pays the bonus or becomes legally bound to provide the bonus (by affirmative commitment or otherwise). Negative discretion will be ignored, and the participant will be treated as having a legally binding right to compensation, if the discretion (i) lacks substantive significance or (ii) is exercisable only on a condition. Negative discretion will be deemed to lack substantive significance if the participant has effective control over or is related to the person who can exercise the negative discretion, or has effective control over any part of the compensation of such person.

Defining a "Substantial Risk of Forfeiture"

As the Preamble to the Proposed Regulations observes, the "definition of a substantial risk of forfeiture is central to the application of Section 409A." The existence of a substantial risk of forfeiture may determine whether an amount is even subject to Section 409A or whether the payment of such amount is eligible for exclusion under the short-term deferral rule, which is discussed below. Also, the lapsing of a substantial risk of forfeiture governs the potential timing of income inclusion in the event of a violation of Section 409A. Generally, the Proposed Regulations adopt a definition similar to the one used under Section 83 of the Code, subject to certain exceptions. Thus, compensation is subject to a substantial risk of forfeiture if it is conditioned on the performance of substantial future services or the occurrence of a condition related to the purpose of the compensation and the possibility of forfeiture is substantial. A condition related to the purpose of the compensation must involve the participant's performance or the employer's business activities or goals. Accordingly, achievement of a prescribed level of sales by the employee or a public offering of the employer's stock would be valid conditions. The special exceptions to the Section 83 definition of substantial risk of forfeiture under the Proposed Regulations are the following:

- No addition of a risk of forfeiture, or extension of the period during which the compensation is subject to an existing risk of forfeiture, will be recognized for purposes of Section 409A; and
- Noncompetition restrictions on deferred compensation will not be deemed to be a substantial risk of forfeiture.

For purposes of determining whether the possibility of forfeiture is "substantial," a facts and circumstances test will apply where the employee entitled to the forfeitable compensation owns a significant amount of the equity or voting power of the employer. Relevant facts and circumstances include the employee's level of control of the employer in relation to other equity holders, directors and officers, as well as the extent to which the employer has enforced such restrictions in the past. This is a potential minefield for owner-employees and others who have significant control or potential control over their employers and rely on a substantial risk of forfeiture to avoid application of Section 409A to certain compensation.

Exception for Short-Term Deferrals

The Proposed Regulations contain an important exception from Section 409A for certain short-term deferrals of compensation. Under this rule, compensation arrangements under which payment is made promptly after the amount becomes earned or vested are not subject to Section 409A. Compensation will qualify for the short-term deferral exception if the compensation is actually or constructively received by the participant by the later of (i) the date that is 2½ months from the end of the participant's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture (*i.e.*, becomes vested), or (ii) the date that is 2½ months from the end of the employer's taxable year in which the amount is no longer subject to a substantial risk of forfeiture.

Under the Proposed Regulations, the payment deadline does not have to be set forth in writing for the short-term deferral exception to be available. Regardless of whether the deadline is set forth in

writing, so long as the amount is actually paid by the applicable deadline, Section 409A will not apply to the arrangement. If payment is not made by the applicable deadline, however, the arrangement will be ineligible for the short-term deferral exception, and Section 409A will be applicable to the arrangement. If an arrangement includes a specified payment date that is later than the short-term deferral deadline, Section 409A will apply to the arrangement even if the payment is in fact made before the deadline.

Even though the payment deadline is not required to be in writing, there are distinct advantages to having a specified payment date. If the deadline is not in writing, an automatic Section 409A violation will occur if payment is not actually made by the deadline (unless the delay in payment is due to unforeseen administrative or solvency issues, as discussed below). If an arrangement does specify a payment date, however, a late payment will not necessarily result in a Section 409A violation. As will be discussed in a future Alert, the Proposed Regulations provide limited relief in cases of the late payment of amounts due by a specified date if (i) payment is made within the same calendar year or (ii) the delay is attributable to a reasonable determination that the amount would not be deductible due to application of Internal Revenue Code Section 162(m) or that payment of the amount would violate a loan covenant or similar contractual provision.

The short-term deferral exception will apply to an arrangement even if payment is made after the applicable deadline if it is established that making the payment on a timely basis was administratively impractical or would have jeopardized the solvency of the service recipient, but only if (1) the impracticality or insolvency was unforeseeable as of the date the service recipient first had a legally binding right to the compensation and (2) payment of the compensation is made as soon as reasonably practicable.

Stock Options and Stock Appreciation Rights

Basic Rule for Stock Options and SARs

The Internal Revenue Service first published guidance on the applicability of Section 409A to certain types of equity compensation in Notice 2005-1, which was issued in December 2004. The guidance in Notice 2005-1 was particularly restrictive for stock appreciation rights (SARs). Notice 2005-1 subjected SARs to all of the Section 409A restrictions and requirements except for certain SARs of public companies that could be settled only in stock. Thus, all SARs of private companies and all SARs that could be settled in cash were to be subject to Section 409A unless eligible for protection under a narrow grandfather rule.

Fortunately, the Proposed Regulations treat SARs in the same manner as stock options. A SAR or stock option will be subject to Section 409A only if either: (i) the exercise price is or can at any time be less than the fair market value of the underlying stock at the date of grant (*i.e.*, the stock option or SAR is "discounted") or (ii) the stock option or SAR has some other feature for the deferral of compensation (except the right to receive unvested stock upon exercise). Even if an option or SAR does not comply with these requirements, however, it will still be exempt from Section 409A to the extent the terms of the option or SAR only permit exercise during the short-term deferral period.

Dividend Equivalents

Some companies grant "dividend equivalent" rights in conjunction with stock options or SARs. These rights entitle the grantee to receive an amount equal to the dividends that would have been paid to the grantee had the shares of stock underlying the options or SARs been issued and outstanding from the grant date to the exercise date. The Proposed Regulations provide that the payment of accumulated dividend equivalent amounts at the time the option or SAR is exercised will be treated as a reduction of the exercise price of the option or SAR. This treatment could subject an otherwise exempt option or SAR to the requirements of Section 409A (because the exercise price would, in effect, be below market on the date of grant).

The Proposed Regulations state that a dividend equivalent right will not result in the disqualification of an option or SAR for the exception from Section 409A if the dividend equivalent right is explicitly set forth as a separate arrangement that complies with Section 409A or separately qualifies for an exception from Section 409A (such as the short-term deferral exception). Under this separate arrangement, the dividend equivalent payments would have to be made at some time other than upon exercise of the stock option or SAR. For example, the arrangement could

provide that accumulated dividend equivalents will be paid by March 15 of the year following the year in which the related dividends are declared and paid.

Definition of Service Recipient Stock

The exception from Section 409A for certain stock options and SARs applies only to options and SARs relating to the stock of the company that is the service recipient. Options or SARs on stock of an unrelated company do not qualify for the exception. The Proposed Regulations establish rules for determining which stock qualifies as a "service recipient stock." Of course, stock of the entity that actually receives the services will qualify. In addition, stock issued by a parent or subsidiary or other company that is related to the actual service recipient may also qualify.

Section 409A provides that, for purposes of determining the identity of the service recipient for this purpose, aggregation rules similar to the rules in Section 414(b) and (c) of the Internal Revenue Code apply. Sections 414(b) and (c) apply an 80% ownership test for purposes of determining related-company status. The Proposed Regulations provide, however, that for purposes of Section 409A, the aggregation rules are to be applied using a 50% rather than 80% ownership test. A 20% control test may be applied where the use of such stock is due to legitimate business criteria, such as in the case of stock options or SARs granted to employees of a joint venture who were former employees of a corporation with at least a 20% interest in the joint venture.

Service recipient stock includes only common stock that has the highest aggregate value of any class of common stock of the service recipient, or a class of common stock that is substantially similar to such class (ignoring differences in voting rights). Options or SARs relating to preferred stock or a separate class of common stock created for the purpose of compensating service providers will not qualify for the exception from Section 409A. However, the Proposed Regulations provide that stock of the service recipient may include American Depositary Receipts (ADRs), provided that the stock to which the ADRs relate would otherwise qualify as service recipient stock. In addition, the Proposed Regulations expand the exclusion for SARs to include equity appreciation rights with respect to mutual company units.

In the case of a corporation whose primary purpose is to serve as an investment vehicle with respect to that corporation's interest in entities other than the service recipient, options and SARs granted to persons who are not primarily engaged in providing services directly to such corporation will be subject to Section 409A.

Stock Valuation

In order to determine whether a stock option or SAR is discounted and, therefore, subject to Section 409A, it is necessary to determine the fair market value of the underlying stock on the date of grant. The Proposed Regulations contain stock valuation rules for both public and private companies.

Publicly-Held Companies

If the stock subject to an option or SAR is readily tradable on the established securities market, fair market value can be determined using the last sale before or the first sale after the grant, or the closing price on the trading day before or the trading day of the grant, or any other reasonable basis involving actual stock transactions so long as the method is consistently applied. An average trading price over a period of time may be used, but only if the applicable period occurs within the thirty days before or thirty days after the grant date, and the terms of the grant are irrevocably set before the beginning of the measurement period.

Privately-Held Companies

For companies whose stock is not readily tradable on an established securities market, fair market value may be determined through the reasonable application of any reasonable valuation method. The determination of whether a valuation method is reasonable, or whether the application of a valuation method is reasonable, is made based on the facts and circumstances as of the valuation date. The factors to be considered under a reasonable valuation method include, as applicable, the following:

- the value of tangible and intangible assets of the corporation,
- the present value of future cash flows of the corporation,
- the market value of stock or equity interests in similar corporations and other entities engaged in trades or businesses substantially similar to those engaged in by the corporation whose stock is to be valued,

- other relevant factors such as control premiums or discounts for lack of marketability, and
- whether the valuation method is used for other purposes that have a material economic effect on the employer, its stockholders or its creditors.

The use of a valuation method is not reasonable if it does not take into account all available information material to the value of the corporation. If a valuation method is applied reasonably and consistently, the value determined by that method will be presumed to equal fair market value, and this presumption will be rebutted only by a showing that the valuation is grossly unreasonable. To be "used consistently," a valuation method must be the same for all equity-based compensation, including for all put and call rights applicable to the stock issuable upon exercise of the stock options or SARs.

The Proposed Regulations identify three valuation approaches that will be presumed to be reasonable:

- The use of an appraisal for determining stock value will be presumed reasonable if the appraisal satisfies the stock valuation requirements applicable to employee stock ownership plans (ESOPs). If these appraisal requirements are met, the appraised value will be presumed reasonable for a period of one year beginning on the date as of which the stock is valued. For example, if an appraisal values stock as of December 31, 2006, that appraised value will be presumed reasonable through December 31, 2007.
- The valuation rules for so-called "nonlapse" restrictions that require the holder to sell stock only at a formula price based on book value, a reasonable multiple of earnings or a combination of such formulas will be entitled to a presumption of reasonableness only if such formula acts essentially as a substitute for stock value. This means that the same valuation formula must be used consistently for both compensatory and noncompensatory purposes in all transactions requiring the valuation of the stock, including regulatory filings, loan covenants and the like.
- A valuation of illiquid stock of a start-up corporation will be presumed reasonable if it is made reasonably and in good faith and is evidenced by a written report that takes into account all of the relevant factors prescribed generally for valuations under the Proposed Regulations. Illiquid stock of a start-up corporation refers to stock of a company that is in its first ten years of the active conduct of a trade or business and has no equity securities that are readily tradable on an established securities market, but only if such stock is not subject to any put or call obligation of the service recipient or any other person (other than a right of first refusal). This valuation rule does not apply if the participant or employer reasonably may anticipate at the time the valuation is applied that the employer will undergo a change in control or a public offering within the next twelve months. A valuation will not be treated as made reasonably and in good faith unless it is performed by a person with significant knowledge and experience or training in performing similar valuations.

Similar valuation rules apply for purposes of any put or call rights to which stock underlying a stock option or SAR is subject.

Modifications of Stock Options and SARs

The modification of an outstanding stock option or SAR is treated as the grant of a new option or SAR. The significance of this treatment is that if the new grant has an exercise price that is less than the fair market value of the underlying stock on the date of the new grant, the new grant would not qualify for the exclusion from coverage under Section 409A. For example, if there is a modification to an option that was originally granted with an exercise price of $10 per share, and if at the time of the modification the fair market value of the underlying stock is $15 per share, the new grant will not qualify for the exclusion from Section 409A unless the option is "repriced" to have an exercise price of at least $15 per share.

The term "modification" means any change to an option or SAR that may provide the holder with a direct or indirect reduction of the exercise price or an additional deferral feature, or an extension or renewal of a stock option or SAR, regardless of whether the holder actually benefits from the change. The Proposed Regulations provide that the following actions are not considered modifications:

- the addition of a provision permitting the transfer of a stock option or SAR;
- the acceleration of the exercise date of a stock option or SAR;

- the cashout of a stock option or SAR for the amount otherwise available upon exercise;
- the addition of a right to have shares withheld or delivered to pay the exercise price and/or withholding taxes with respect to an option or SAR;
- the extension of the option or SAR exercise period to a date not beyond the later of (i) the fifteenth day of the third month following the date the right would otherwise have expired or (ii) December 31 of the calendar year in which the right would otherwise have expired; and
- the extension of the exercise period of an option or SAR under circumstances where the exercise would violate applicable securities laws, but only if the expiration date is extended to a date no later than thirty days after restrictions on exercise are no longer required to avoid a securities law violation.

In connection with corporate mergers, reorganizations and similar transactions, stock options and SARs issued by the target company are often assumed by the acquiring company (an assumption) or canceled in exchange for new awards issued by the acquiring company (a substitution). Under the Proposed Regulations, the assumption or substitution of stock options or SARs will not be treated as a grant of a new right if the requirements of Treasury Regulation Section 1.424-1 (which previously applied only to incentive stock options) are met. However, the Proposed Regulations provide that, for Section 409A purposes, the requirements of Treasury Regulation Section 1.424-1 will be deemed satisfied even if fewer options or SARs with a greater per-share spread can be issued so long as the aggregate spread remains the same.

For spinoffs and similar transactions, as well as other corporate transactions, adjustments or substitutions may be based on a market quotation as of a predetermined date not more than sixty days after the transaction or based on an average of market prices over a period of not more than thirty days ending no later than sixty days after the transaction.

The Proposed Regulations include a provision stating that if an inadvertent modification is rescinded before the earlier of the date any additional right granted under the modification is exercised or the end of the calendar year in which the modification was made, the modification will not be treated as a material modification of the plan.

Restricted Property

The Proposed Regulations state that restricted stock or other restricted property is not deferred compensation merely because taxation is delayed as a result of the fact that it is nontransferable and subject to a substantial risk of forfeiture. However, a plan under which a participant obtains a legally binding right to receive property (whether or not the property is restricted property) in a future year may be a nonqualified deferred compensation plan.

Arrangements Between Partnerships and Partners

The Treasury Department and the Internal Revenue Service continue to analyze the application of Section 409A to partnership compensation arrangements. Notice 2005-1 provides interim guidance on partnership issues and until further guidance is issued, taxpayers may continue to rely on Notice 2005-1. In addition, until further guidance is issued, Section 409A will apply to guaranteed payments described in Code Section 707(c) (and rights to receive such guaranteed payments in the future), only in cases where the guaranteed payment is for services and the partner providing services does not include the payment in income by the fifteenth day of the third month following the end of the taxable year of the partner in which the partner obtained a legally binding right to the guaranteed payment or, if later, the taxable year in which the right to the guaranteed payment is first no longer subject to a substantial risk of forfeiture.

Foreign Plans and Arrangements Subject to Section 409A

As the globalization of business continues to expand, more employers have employees working abroad and are bringing foreign individuals to work in the U.S. Neither Section 409A nor Notice 2005-1 dealt directly with the application of Section 409A to these circumstances. The Proposed Regulations provide guidance in this area primarily by focusing on the status of the participant who is receiving deferred compensation.

U.S. Citizens

U.S. citizens typically are subject to the U.S. federal tax rules on all compensation, whether earned in the U.S. or abroad, and regardless of the source. Consequently, Section 409A generally applies to compensation plans and arrangements for U.S. citizens. The Proposed Regulations provide exclusions to Section 409A for the following types of compensation:

- Deferred compensation that qualifies as "foreign earned income" under Section 911 of the Code and that, when added to the participant's other foreign earned income for the year, does not exceed the maximum allowance under Section 911;
- Amounts that are not subject to U.S. taxation under a treaty;
- Nonelective amounts qualifying as foreign earned income that are contributed to certain foreign broad–based retirement plans and which do not exceed the annual limits on qualified retirement plan contributions or benefits under Section 415 of the Code; and
- Amounts contributed to a funded trust under a foreign plan that are taxable under Section 402(b) of the Code.

Resident Aliens

Resident aliens working abroad generally are subject to the same rules and exclusions as U.S. citizens working in foreign countries. However, the Proposed Regulations contain two special provisions for resident aliens. First, there is an exclusion for any amounts previously deferred while working abroad as a nonresident alien. Second, in the initial year in which the participant becomes a resident alien, special transition rules allow for changes in the participant's compensation arrangements to be made through the end of that year to either comply with or avoid application of Section 409A.

Nonresident Aliens

Deferred compensation earned by nonresident aliens for services performed in the U.S. is subject to Section 409A, unless such compensation is not subject to U.S. taxation under the Internal Revenue Code or a treaty. However, the Proposed Regulations offer exceptions to this rule for amounts deferred under certain foreign broad-based retirement plans and amounts not exceeding $10,000 per year.

Other Compensation That Is Excluded From Section 409A

The Proposed Regulations also provide exclusions from Section 409A for the following arrangements:

- Certain tax-equalization arrangements providing compensation to a participant where the taxes in the participant's foreign work location exceed the taxes that would have been paid under the U.S. tax system; and
- Totalization arrangements that make up the difference in contributions to or payments from a foreign social security system to reflect the benefits to which the participant would have been entitled under the U.S. Social Security system.

Separation Pay Arrangements

The Proposed Regulations clarify the application of Section 409A to severance and separation pay plans and arrangements and provide additional exclusions from Section 409A for such compensation. Notice 2005-1 allowed exclusion of collectively bargained severance plans and broad-based plans and arrangements that did not cover certain key executive employees. The Proposed Regulations make the collectively bargained plan exclusion permanent. While no exclusion is made in the Proposed Regulations for broad-based arrangements, the Proposed Regulations do provide relatively broad new exclusions that should cover most broad-based arrangements, as well as certain other carefully designed separation pay arrangements. It should be noted that to qualify as "separation pay" subject to the exceptions discussed below, a participant typically must have a "separation from service." The concept of separation from service will be discussed in a later Alert.

Application of Short-Term Deferral Exclusion to Separation Pay

Often, a separation pay arrangement will not be subject to Section 409A because it provides for payment immediately following termination, or otherwise within the period qualifying for the short-term deferral exclusion from Section 409A discussed above. However, if the separation pay arrangement creates a legally binding right to compensation and is not otherwise subject to a substantial risk of forfeiture prior to the employee's actual termination, the short-term deferral exclusion likely will not be available. Consequently, a lump sum payment of severance immediately following a termination without cause

generally would be exempt from coverage under Section 409A because the condition that payment occurs upon a termination without cause is a substantial risk of forfeiture and the payment is made within 2½ months after the year in which the substantial risk of forfeiture lapsed (*i.e.*, the termination without cause occurred). However, many employment agreements and other arrangements providing for separation pay include constructive discharge provisions allowing an employee to resign with "good reason." The Preamble to the Proposed Regulations notes that no categorical exclusion applies for "good reason" terminations and requests comments on how Section 409A should be applied to such arrangements. This raises questions as to whether, or to what extent, the Internal Revenue Service views constructive discharge provisions as substantial risks of forfeiture.

Special Exclusion for Capped Involuntary Separations

The Proposed Regulations add an exclusion from Section 409A for separation pay arrangements in the event of an involuntary separation from service if the total amount paid does not exceed two times the participant's annual average compensation and all payments are made no later than the end of the second calendar year following the separation. However, the amount that can be paid under this exclusion is capped at two times the annual compensation limit that applies to qualified retirement plans under Section 401(a)(17) of the Code. That amount is indexed to inflation and is currently $210,000. Accordingly, for 2005, this exclusion is capped at $420,000.

Reimbursement Arrangements

The Proposed Regulations provide an exception for arrangements that reimburse certain expenses of a participant following a separation from service. Reimbursable expenses subject to the exemption are certain nontaxable expenses, deductible business expenses, medical expenses, moving expenses, outplacement expenses and certain in-kind benefits (*e.g.*, office space). Reimbursements under the arrangement must be made no later than the end of the second calendar year following the separation. Also, *de minimis* reimbursements or separation pay allowances that do not exceed $5,000 in the aggregate are excluded from the application of Section 409A.

Separation Pay and Plan Aggregation Rules

Under Notice 2005-1, compensation deferred by a participant under a particular plan or arrangement is aggregated with compensation deferred under similar types of plans and arrangements. The Proposed Regulations specify separation pay plans and arrangements as a separate "type" of deferred compensation arrangement for aggregation purposes. Consequently, a violation with respect to a participant's separation pay arrangement will not be deemed to be a violation of any other deferred compensation arrangement in which the employee participates that is not a separation pay arrangement.

Split Dollar Life Insurance Arrangements and Section 409A

Although the Proposed Regulations do not provide a blanket exclusion for all split dollar life insurance arrangements, the Preamble indicates that such arrangements may be eligible for the "death benefit plan" exemption from coverage and that arrangements treated as loans under the split dollar regulations would not create deferred compensation subject to Section 409A as long as certain requirements are met. However, the Preamble notes that arrangements structured under the endorsement method contained in the split dollar regulations may be covered by Section 409A. The Internal Revenue Service has requested comments on the application of Section 409A to split dollar arrangements, and we can expect more guidance on this subject in the future.

Aggregation of Plans and Arrangements

The Proposed Regulations generally adopt the aggregation rules contained in Notice 2005-1. These rules provide that all plans or arrangements of a similar type in which a participant participates are aggregated and treated as a single plan. The Notice identified three "types" of plans: individual account or account balance plans, nonaccount balance plans (*e.g.*, defined benefit pension plans) and all other arrangements (including stock and equity-type plans). As noted above, the Proposed Regulations add a fourth category for separation pay plans and arrangements. Consequently, a violation of Section 409A with respect to an account balance type of deferred compensation plan in which a participant participates will cause the participant to include in

income, and be subject to a 20% excise tax on, all amounts deferred by the participant under any account balance deferred compensation plan. However, that violation will not affect the participant's deferred compensation under any equity compensation, severance pay or other type of deferred compensation plan. The Proposed Regulations also clarify that if a Section 409A violation is not an isolated incident or involves a significant number of participants, the violation may be deemed to apply to all participants in that plan or arrangement, even if a particular participant did not directly benefit from the violation.

Plans Must Be In Writing

Although not explicitly required under Section 409A itself, the Proposed Regulations require that the material terms of a plan or arrangement covered by Section 409A must be in writing. The material terms include the amount of deferred compensation, or the formula or other method for determining such amount, to be provided under the arrangement and the time that amount will be paid. The Proposed Regulations allow plans or arrangements to be put in writing by the end of the calendar year in which the employee has a legally binding right to the deferred compensation, or within 2½ months after the end of such year if the employee is not entitled to receive the payment during that following year. However, under the transition rules of the Proposed Regulations, plans and arrangements do not have to be in writing until December 31, 2006, and will be treated as established as of the later of the date they were adopted or otherwise effective.

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