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IRS Issues Final Section 409A Regulations

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On April 10, after keeping the executive compensation community in suspense for the better part of a year, the IRS issued its final regulations under Section 409A of the Internal Revenue Code of 1986, as amended (the “Code”). Although the final regulations are certainly *not* going to be the IRS’s “final” word on Section 409A matters,^[fn1] they do provide comprehensive guidance for most of the key aspects of deferred compensation arrangements and offer a reasonably clear path towards compliance. The final regulations are generally effective on January 1, 2008, but as we discuss below, taxpayers can rely on the final regulations now.

In their informal comments over the past few months, IRS officials had indicated that the final regulations would not make wholesale changes to the rules set forth in the proposed regulations and prior guidance. True to its word, the IRS has used the final regulations to clarify and add flexibility to many aspects of the proposed regulations while retracting only a few of their provisions. As a general observation, the final regulations give relief to many common deferred compensation administrative practices that were problematic under the proposed regulations but also tighten up a number of provisions in such a way that avoiding Section 409A completely is likely to become more difficult. In addition, although the final regulations do not impose a significant number of documentary requirements (*i.e.*, requirements to include particular provisions in deferred compensation arrangements), the ones they do impose will require careful attention from drafters to avoid inadvertent violations.

Because the final regulations weigh in at just under 400 pages, this *Legal Update* does not attempt to summarize and explain every area they address.^[fn2] Instead, we have attempted to highlight the key clarifications offered by the final regulations and point out areas where the IRS has made changes from its prior pronouncements under Section 409A.

A word about Section 409A terminology: Many of our readers will be only too familiar with the terminology used by the proposed regulations to deal with Section 409A. Nonetheless, for the sake of clarity, we call your attention to the following two defined terms that will be used throughout.

- Service Provider: A “service provider” is either a common law employee or independent contractor who provides services to a “service recipient.”
- Service Recipient: An entity that receives the services rendered by a service provider. It is important to bear in mind that a “service recipient” includes not only the entity to whom an employee or contractor directly provides services but also other entities that are in the same “controlled group.”^[fn3]

Coverage of the Final Regulations

Covered Arrangements.^[fn4] The final regulations do not make major changes to the scope of coverage for Section 409A and instead generally track the proposed regulations’ definition of “nonqualified deferred compensation plan.” The final regulations clarify that an arrangement will generally be deemed to provide for a deferral of compensation if it *could* result in payment in a year after the year in which the compensation is earned.^[fn5] This subtle clarification expands the potential universe of arrangements to which Section 409A can apply while simultaneously limiting

access to the various exceptions to coverage.

Excluded Arrangements. The final regulations preserve the classes of excluded plans, agreements, and other arrangements set forth in the proposed regulations (e.g., tax-qualified retirement plans, bona fide sick leave or vacation plans, certain medical reimbursement arrangements, etc.) but clarify that reimbursements made under welfare benefit plans providing taxable benefits to service providers are not excluded. Arrangements providing welfare benefits that are excluded from income under Code Sections 105 and 106 remain outside the scope of Section 409A. The practical effect of this carve-out is that benefits provided under discriminatory self-funded health plans will be subject to Section 409A.

Short-Term Deferrals. One of the more useful exceptions to Section 409A coverage described in the proposed regulations was the short-term deferral rule. As refined in the final regulations, the short-term deferral rule generally excludes from Section 409A coverage an arrangement under which a payment is made no later than the 15th day of the third month following the year in which the service provider “earns” a vested right to the payment. However, if the arrangement provides for any payment that *might* be made or triggered after this deadline, the exception will not be available, even if, in fact, the payment was actually made before the deadline. As a result, in many instances, the short-term deferral rule will not be available for payments made upon a specified event (e.g., termination of employment) after a service provider has earned a vested right to receive them because the payment that could fall outside the short-term deferral period. In addition, even if a payment is made by the deadline, if the arrangement under which it is made specified a possible later payment date, the exception will not be available.

Stock Rights. The final regulations generally adopt the approach to “stock rights” set forth in the proposed regulations. In general, this means that incentive stock options (including employee stock purchase plans) and non-discounted non-statutory options and stock appreciation rights will be excluded from coverage under Section 409A unless they include deferral features or relate to non-service recipient stock; restricted stock and other property continues to be excluded from coverage in most instances.^[fn6] Discounted non-statutory stock options, “synthetic” stock rights (e.g., phantom stock, restricted stock units, etc.), and stock rights covering non-“service recipient stock” continue to be covered by Section 409A under the final regulations.

Expansion of Eligible Stock Classes. One area of special concern under the proposed regulations related to the identification of “service recipient stock” for purposes of stock rights; under the proposed regulations, if a stock right was granted on the “wrong” class or type of stock, the stock right would be subject to Section 409A from its grant, regardless of its exercise price. While the final regulations continue to generally preclude the use of preferred stock,^[fn7] they do provide that any class of common stock may be used for the purpose of stock right grants, even where another class of common stock in the service recipient’s controlled group is publicly-traded or has a higher aggregate value outstanding or where the common stock at issue is subject to transferability restrictions or buy-back rights at fair market value. However, the final regulations also indicate that even if the stock at issue would otherwise qualify as “service recipient stock,” only if it is issued by the corporation for which the service provider works at the date of grant (*i.e.*, the direct service recipient) or any higher-level corporation (or other entity) holding a controlling interest in the direct service recipient will it avoid Section 409A coverage. In other words, options for a subsidiary’s stock granted to an employee of the parent company would not avoid Section 409A, but an option in the parent company’s stock granted to an employee of its subsidiary would not be subject to Section 409A absent some other basis for coverage (e.g., additional deferral feature, discounted exercise price, etc.).

For service recipients that consist of multiple entities, the final regulations indicate that service recipient stock may include the stock of the particular group member for whom the service provider was providing services at the time of grant or of another controlled group member. For the purpose of identifying controlled group members, the final regulations generally adopt the rules applicable under Code Section 414(c) and its related regulations but require only 50% common ownership rather than 80%. Where valid business criteria exist for using a lower ownership threshold, the final regulations permit a common ownership threshold of as low as 20%.

Valuation of Service Recipient Stock. Another topic of considerable interest under the proposed regulations involved the valuation of service recipient stock. As with the proposed regulations, the final regulations indicate that stock rights granted at a discount from fair market value are subject to Section 409A.

The final regulations liberalize the valuation consistency requirement included in the proposed regulations by indicating that different valuation methods can be used for different purposes with respect to the same grant, although each method must otherwise qualify as reasonable. Further, once the exercise price for a stock right has been established using a particular valuation method, that price cannot subsequently be changed using an alternative method. In addition, if the service recipient stock to which a stock right relates becomes publicly-traded after grant but prior to exercise, the service recipient must thereafter use a valuation method to publicly-traded stock to determine the grantee's payment or buy-back amount.

The final regulations generally adopt the proposed regulations' requirements for valuing stock that is readily tradable on the public markets. For purposes of identifying stock as "readily tradable," the final regulations incorporate the relevant portions of the Code Section 280G regulations. In response to comments, the final regulations permit the use of average prices for publicly-traded stock as long as the other terms of the grant are fixed prior to the beginning of the averaging period. Further, the final regulations permit the use of average pricing to satisfy applicable foreign law requirements as long as the averaging period does not exceed 30 days.

For purposes of valuing non-publicly traded stock, the final regulations generally adopt the valuation methods applied by the proposed regulations. The final regulations continue the three safe harbor valuation methods described in the proposed regulations (e.g., independent appraisal, generally-applicable repurchase formula, and, for illiquid stock of a start-up company, a valuation by a qualified individual applied at a time when the company does not anticipate a public offering or change in control). In addition to the factors included in the proposed regulations for use in determining the fair market value of stock, the final regulations include recent equity sales by the corporation in arm's-length transactions.

For purposes of the start-up company valuation method, the final regulations shorten the delay period between a valuation and a change in control or public offering from 12 months to 90 days in the case of a change in control and 180 days in the case of a public offering. The final regulations also provide guidance for identifying qualified, non-professional appraisers.

Modifications to Stock Rights. Although the final regulations continue to treat the extension of the exercise period for a stock right as providing an additional deferral feature as of the original date of grant, the IRS has expanded the situations in which such an extension will not automatically run afoul of Section 409A. Under this expanded rule, the extension of an option exercise period will not constitute an additional deferral feature or modification if the extension does not exceed the original term of the option or 10 years from the original date of grant, whichever is earlier. In addition, the final regulations permit the extension of the exercise period for an underwater option without subjecting the option to Section 409A.

For substitutions or assumptions of stock rights in connection with corporate transactions, the final regulations retain the approach described in the proposed regulations by adopting the provisions in the Code Section 424 regulations relating to substitutions and assumptions of incentive stock options. Further, the final regulations clarify that a substituted non-statutory stock option can be treated as a continuation of the initial option even if the grantee is not employed by or otherwise providing services to the successor entity, as long as the substitution otherwise follows the regulatory requirements.

Under the proposed regulations, it was not clear what effect a modification to an incentive stock options would have for purposes of Section 409A coverage. The final regulations clarify that Section 409A coverage for incentive stock options must be reassessed at the time they are modified. However, an incentive stock option will only be regarded as a new grant or as having incorporated an additional deferral feature from its original grant date if the modification or other event would have been treated as such if the option had been a non-statutory option at the time.

Partnership Interests. The final regulations continue to reserve the issue of Section 409A's application to arrangements between partners and partnerships and indicate that, pending further guidance, the relevant provisions of the proposed regulations and Notice 2005-1 remain effective.

Separation Pay Arrangements. The final regulations offer significant clarifications about the IRS's view of separation pay arrangements while generally adopting the requirements set forth in the proposed regulations. Arrangements that provide "separation pay" and otherwise satisfy these requirements will be exempt from Section 409A. Notably, "separation pay" consists only of compensation payable to a service provider upon his or her separation from service and does not

include amounts that could be payable without a separation from service. Thus, an arrangement providing for payments upon an employee's separation from service or a change in control event would not be treated as separation pay under the final regulations.

The final regulations clarify that the various exceptions for separation pay arrangements (e.g., certain reimbursement arrangements, arrangements providing solely for separation pay in connection with "window" or involuntary separation programs, de minimis separation pay benefits, etc.) may be applied separately to the various benefits offered under a separation pay arrangement.

A separation pay arrangement is not subject to Section 409A where payments are due only upon an involuntary separation from service, the total amount of payments do not exceed the lesser of two times the service provider's annual compensation or two times the applicable limit under Code Section 401(a)(17) (\$225,000 for 2007) and are completed by the end of the second year following the year of the involuntary separation from service. For involuntary separation pay arrangements that otherwise fit into this exception, the final regulations indicate that only amounts in excess of the applicable limit will be subject to Section 409A. This clarification offers a way for at least some separation pay benefits to be provided immediately following separation from service, even for specified employees whose payments would otherwise be subject to a six-month delay.

As in the proposed regulations, the final regulations indicate that any amounts that are substituted for or replace previously-deferred amounts under separate deferral arrangements will remain subject to the requirements that were applicable to the original deferral arrangements. The final regulations create a presumption that any payment following a voluntary separation from service is an accelerated payment of any deferred compensation right that was forfeited upon the separation from service. As a result, accelerated or deferred payments would be subject to Section 409A. The final regulations provide various factors that can be used to rebut this presumption, including where the payments that are ultimately made are materially less than the present value of the forfeited deferred compensation amounts.

The final regulations continue to exclude certain common post-termination reimbursement arrangements from coverage under Section 409A. In a nod to the common practice of offering subsidized COBRA benefits for terminating employees, the final regulations extend the period of time over which taxable reimbursements for COBRA premiums can be provided to the maximum applicable period of COBRA entitlement. Further, reasonable outplacement and moving expenses triggered by a separation from service (voluntary or involuntary) continue to be excluded from coverage as long as the expenses are incurred by the end of the *third* year (rather than the second year as provided in the proposed regulations) following the year of termination. The exception is available for this period of time even if reimbursements continue to be available beyond its end. However, this extension is only available for the reimbursement of expenses incurred by service providers; for benefits provided in kind, the reimbursement period continues to be the end of the second year following separation from service.

The final regulations increase the amount of de minimis severance pay that can be provided without triggering Section 409A coverage to the applicable dollar amount under Code Section 402(g)(1)(B) for the year of termination to the applicable dollar amount under Code Section 402(g)(1)(B) for the year of termination (i.e., \$15,500 for 2007). This exception applies to any type of separation pay plan, but applies only once with respect to all amounts paid to the service provider by the service recipient.

Settlements. In a helpful development, the final regulations exclude from coverage settlements or awards resolving bona fide legal claims relating to wrongful termination, employment discrimination, FLSA, and worker's compensation statutes, regardless of the law under which the claims arise and regardless of the status of the settlement proceeds as compensatory payments. Section 409A also will not apply to the payment or reimbursement of attorney's fees incurred in connection with the enforcement of such a claim. The final regulations emphasize that this exception only applies to bona fide claims and does not allow for the wholesale restructuring of the terms governing preexisting deferrals of compensation. For example, a settlement could not change the timing of payments of deferred compensation subject to Section 409A except as otherwise permitted by the final regulations. A payment made in connection with a service provider's execution of a waiver of claims does not necessarily mean that the payment was made in connection with the settlement of a bona fide claim.

Documentation Requirements. The final regulations provide that an arrangement subject to Section 409A must generally set forth the time or times when payments will be made (or the objective, non-discretionary formula according to which the amounts will be determined) and the

payment schedule or triggering events in writing at the time an amount is deferred. It is not necessary for an arrangement to be set forth in a single, integrated document, however. In addition, an arrangement must include provisions addressing the specified employee delay requirement no later than the time this requirement may become applicable. This will generally mean that an arrangement must include such provisions by the time at which an employee becomes a specified employee.

For deferral elections (whether initial or subsequent), an arrangement must specify no later than the date on which the election is irrevocable the conditions under which the election may be made. It is not necessary to include provisions dealing with accelerated payment events, but the service provider must be able to demonstrate that any accelerated payments satisfy the requirements of Section 409A and the final regulations.

Of some note, the final regulations indicate that Section 409A “savings clauses” will be disregarded to the extent they purport to supersede noncompliant plan terms. However, such provisions may still be valid insofar as they clarify ambiguous terms rather than countermanding express plan provisions.

Substantial Risks of Forfeiture. For purposes of Section 409A, the IRS declined to adopt the reasonably well-developed “substantial risk of forfeiture” guidance issued under Code Section 83 in favor of the more restrictive approach described in the proposed regulations. The final regulations clarify that a payment conditioned on an involuntary separation from service without cause can be a substantial risk of forfeiture if there is a substantial risk of such a termination. Further, “good reason” or constructive discharge terminations can be treated as involuntary in many instances under the final regulations; the proposed regulations had suggested that “good reason” provisions could not be relied upon to create a valid substantial risk of forfeiture.

Requirements for Initial Deferrals

The final regulations generally adopt the requirements in the proposed regulations relating to initial deferral elections. Initial deferral elections must be irrevocable as of the date specified for the type of deferral at issue, and such elections cannot be subject to rescission or modification after the applicable deadline. With respect to bonus deferrals, the final regulations indicate that even where the payment and amount of a bonus is discretionary, an election to defer any bonus that otherwise becomes payable must be made before the year in which the services to which the bonus relates begins, absent another exception (e.g., for performance-based compensation).

While generally retaining the proposed regulations’ approach to deferrals involving performance-based compensation, the final regulations indicate that deferrals relating to performance-based and non-performance-based compensation may be treated separately for purposes of the relevant deadline for making deferral elections. The final regulations offer expanded and clarified rules for dealing with initial deferral elections relating to commissions and provide additional detail for initial deferral elections involving payments made upon voluntary and involuntary separations from service and bona fide negotiated separations not relating to previously-existing legally binding rights.

Elections as to Timing and Form of Payments

Fixed Dates/Specified Events. In general, the final regulations require that a single time and form of payment be specified for each payment to be made at a specified time or upon a specified event. However, it is possible to specify different times and forms of payment depending on whether a permissible payment event occurs before or after a specified date, and in limited circumstances, it is possible to designate different times and forms of payment depending on the conditions under which a service provider separates from service. The final regulations expand upon the proposed regulations to provide that a payment will be considered to have been made at a fixed date or on a fixed schedule if it is made by the later of the end of the calendar year in which the specified date or event occurs or 2½ months thereafter. The final regulations continue to permit the designation of an entire calendar year as a specified date of payment. If an arrangement does not provide for a specific payment date but instead requires payment by a specified deadline, the final regulations will regard the deadline as a specified payment date only if the period during which the payment can be made is limited to a specific tax year or a period of up to 90 days and then only if the service provider is not given any control over the tax year in which the payment is made.

Refinements to Key Definitions

Separation from Service. The final regulations generally track the proposed regulations but simplify the standards used to determine when a service provider who continues to provide limited services following his or her purported separation from service will be regarded as separated in fact and provide various rebuttable presumptions intended to assist in this determination. Subject to certain limitations, the final regulations also permit service recipients to more precisely define the circumstances when a separation from service occurs with respect to a particular service provider.

As noted above, for purposes of identifying the “service recipient,” the final regulations incorporate the controlled group concepts set forth in Code Sections 414(b) and (c) but reduce the ownership threshold from 80% to 50%. A plan is permitted to specify a higher or lower level of ownership within the range of 20% to 80%, although the use of a threshold below 50% must be based on legitimate business criteria.

The final regulations create an elective rule for use in identifying separations from service relating to certain corporate transactions. Under this rule, if a service recipient sells assets (either substantial assets such as a division or business unit or substantially all of its assets) to an unrelated buyer in a bona fide arm’s-length transaction and one or more of the seller’s service providers would otherwise be separated from service, the seller and buyer may specify whether the service providers will be separated from service for purposes of applying the terms of any affected deferred compensation arrangements. The treatment of the service recipients must be specified no later than the closing date of the transaction.

Delay in Payments to Specified Employees. The final regulations clarify that payments to a “specified employee” will be subject to delay where any member of a group of entities comprising the “service recipient” has any service recipient stock that is publicly-traded on any established securities market (including a foreign securities market).

For purposes of identifying specified employees, the final regulations retain the general approach described in the proposed regulations with certain clarifications. The final regulations offer guidance regarding the determination of “compensation” for specified employees and provide several “short cuts” that can be used to administer and apply the six-month delay requirement. The final regulations allow an arrangement to uniformly delay all payments triggered by a separation from service for 6 months without regard to whether the recipients are specified employees. A service recipient may use an alternative method of identifying specified employees in lieu of the standard method as long as the alternative method is reasonably designed to include all specified employees, uses an objectively determinable standard with no direct or indirect elections by service providers, and includes not more than 200 service providers in the class as of any given date. The final regulations suggest that a service recipient should consider including its definition of “specified employee” in all of its deferred compensation arrangements or else retain discretion to make such determinations. The final regulations include detailed but flexible rules for identifying combined groups of specified employees in the context of corporate transactions and public offerings. These rules are significantly different than those included in the proposed regulations.

The final regulations indicate that it is not necessary to delay a payment to a specified employee where he or she receives a payment as a result of a change in control event, unforeseeable emergency, or disability, even if the specified employee subsequently separates from service. Further, a payment can be accelerated to comply with the terms of a domestic relations order, applicable ethics laws, or to pay certain employment taxes.

Disability. The final regulations track the definition of disability included in the proposed regulations. Although disability determinations can be made by any person and the identity of the decision-maker need not be specified, only disabilities that qualify as such under the final regulations will be permissible triggering events for deferred compensation payments. If an arrangement so provides, a determination of total disability by the Social Security Administration or Railroad Retirement Board will be deemed to be a qualifying disability under Section 409A.

Death. “Death” may need no definition, but the final regulations do provide that a deceased service provider’s beneficiary will be subject to the subsequent deferral and anti-acceleration rules to the same extent as the service provider—in other words, there is no special allowance for beneficiaries to alter existing elections as to the form and timing of payments.

Change in Control Events. The final regulations generally adopt the same standards for identifying change in control events as were set forth in the proposed regulations. However, for purposes of a change in effective control of a corporation, the threshold has been lowered from 35% to 30% in the

final regulations.

Pending further guidance from the IRS, change in control events affecting non-stock, non-profit corporations are to be evaluated under the regulatory provisions dealing with changes in the composition of boards of directors as applied by analogy.

With respect to earn-out and similar payments made in connection with change in control events, the final regulations adopt the rule announced in the proposed regulations with a modification directed at payments that are subject to a substantial risk of forfeiture and that are made under terms and conditions that are generally applicable to shareholders of the service recipient or to the service recipient itself. For these types of payments, the short-term deferral rule is applied as if the legally-binding right arose on the date that the payments became subject to a substantial risk of forfeiture and may therefore be available to exempt the payments from Section 409A.

Unforeseeable Emergencies. The Pension Protection Act of 2006 expanded the circumstances in which a distribution may be made in connection with an unforeseeable emergency to include hardship situations involving a service provider's designated beneficiary. The final regulations incorporate this additional provision. In addition, the final regulations clarify that it is not necessary for a service provider to seek payments or loans under a qualified plan, another deferred compensation arrangement subject to Section 409A, or a "grandfathered" deferred compensation arrangement in order to qualify under a deferred compensation arrangement to receive a hardship payment as a result of an unforeseeable emergency.

Permissible Delays in Payment. The final regulations permit the delay of scheduled payments where the delay is caused by a pre-specified, objective, non-discretionary formula related to the service provider's business performance; in this event, the later date for the payment must be controlled by the objective non-discretionary formula. The final regulations reiterate that payments may be delayed to preserve the service recipient's ability to continue as a going concern as long as the payments are made during the first tax year when they would not have that effect; a deferred compensation arrangement need not include an express provision in order to delay payments in this circumstance. The final regulations eliminate the provisions in the proposed regulations permitting payments to be delayed in order to avoid violating a loan covenant or similar contractual obligation but adopt a new provision allowing for delays relating to the application of Code Section 162(m).

Permissible Acceleration Events. The final regulations continue to prohibit the acceleration of deferred compensation payments in most circumstances by adopting more detailed requirements relating to the substitution of current payments for preexisting deferred compensation. In this regard, the final regulations rebuttably presume that a service provider's receipt of a payment of compensation or right to a payment of compensation in close connection with the purported forfeiture or voluntary waiver of previously-deferred compensation is a continuation of the previously-deferred compensation and will therefore remain subject to Section 409A; this presumption can be rebutted by a showing that the compensation would have been paid in any event. The final regulations expressly disallow a service recipient's retention of discretion to accelerate the time of payments even in connection with permissible acceleration events (e.g., death, disability, separation from service, unforeseeable emergency, or change in control); a service recipient may retain discretion to accelerate vesting for deferred compensation as long as the exercise of that discretion does not accelerate the timing of the related payments.

Plan Liquidation. The final regulations adopt the rules described in the proposed regulations relating to the circumstances in which a service recipient may terminate and liquidate a deferred compensation arrangement but decrease the period of time thereafter during which the service recipient is precluded from adopting a new deferred compensation arrangement from 5 years to 3 years. The final regulations also provide that a discretionary plan termination implemented in close connection with a decline in the service recipient's financial health will not be eligible for this exception. The final regulations retain the rule permitting a service recipient to terminate its deferred compensation arrangements within the 30 days preceding or the 12 months following a change in control event but specify that the action taken to wind up the arrangements must be irrevocable.

Bona Fide Settlements. The final regulations permit the acceleration of payments where the right to the payments derives from a settlement of a bona fide dispute between a service provider and service recipient as to the service provider's right to the deferred amount. This exception is limited to the amount in dispute and does not apply to disputes involving only the timing of (rather than entitlement to) payments. A payment that is not at least 25% less than the present value of the deferred amount will be presumed not to constitute a substantial reduction in the value of the deferred amount and will therefore be presumed not to be eligible for this exception. Further, a

payment will be presumed to be ineligible for this exception if it is made in close connection with a decline in the service recipient's financial health.

Cash-Outs. The final regulations generally allow a service recipient to exercise its discretion to accelerate the payment of deferred amounts at any time such amounts are less than the applicable dollar amount under Code Section 402(g)(1)(B) (*i.e.*, \$15,500 for 2007 and indexed for inflation thereafter). The plan aggregation rules apply to this exception such that all eligible amounts must be cashed out of aggregated plans if any amount will be cashed out. Unlike the proposed regulations, the final regulations do not require separation from service as a precondition for this exception. The service recipient can exercise its discretion under this exception whether or not the arrangement expressly so provides.

Cancellation of Deferral Elections. The final regulations generally do not permit a service provider to cancel an existing deferral election except in the case of a service provider's disability or an unforeseeable emergency or hardship. Under the final regulations, the fact that a participant in a deferred compensation arrangement becomes ineligible to participate mid-year will not permit cancellation of his or her deferral election for the remainder of that year. Further, the final regulations specifically note that a participant's exit from a service recipient's "select group of management or highly compensated employees" (relating to the exclusion for so-called "top hat" plans under the Employee Retirement Income Security Act of 1974, as amended) is not a permissible basis for canceling an outstanding deferral election.

Subsequent Deferral Elections

The final regulations generally adopt the requirements for changes to existing deferral elections set forth in the proposed regulations and provide a number of useful clarifications. For example, the final regulations indicate that the addition of death, disability, or unforeseen emergency as potentially *earlier* distribution triggers need not comply with the general rules for subsequent deferral elections. However, this exception does not apply to the addition of any of these events as potentially *later* distribution triggers.

The general anti-acceleration requirement applies to the addition of a specified payment date or payment schedule, a change in control event, or separation from service as a potentially earlier distribution trigger and also applies to the removal of a distribution trigger from a plan term requiring payment upon the later of two events. In these situations, the subsequent deferral rules are applicable, and the substituted distribution trigger cannot be effective for at least 1 year and must provide for payments to occur upon the later of 5 years from the originally-specified distribution trigger or the substituted distribution trigger.

For purposes of the subsequent deferral rules, the final regulations except changes to the timing and form of payments made in accordance with a domestic relations order to the extent the changes apply to the alternate payee and not to the service provider.

Effective Dates

The final regulations are generally effective on January 1, 2008, although in many instances, they can be relied upon now. Beyond this general rule, the IRS has included detailed guidance for the administration and amendment of deferred compensation arrangements under the proposed regulations and prior guidance pending the effective date of the final regulations. The final regulations also offer guidance relating to certain determinations involving stock rights (*e.g.*, identification of service recipient stock and valuation issues) and the administration and modification of "grandfathered" arrangements (*i.e.*, arrangements pre-dating the enactment of Section 409A).

Footnotes

[1] The preamble to the final regulations notes various areas in which further regulatory or administrative guidance is anticipated, including the operation of "grandfathered" arrangements, the application of Section 409A to partnership interests, and reporting and withholding requirements for arrangements subject to Section 409A.

[2] Readers desiring a more detailed consideration of Section 409A's requirements under the

proposed regulations should refer to our prior *Legal Updates*, available at www.mofo.com. This *Legal Update* can be read as a supplement to those prior publications because the final regulations left much of the substance in the proposed regulations intact. A word of caution, however: taxpayers cannot generally rely on the proposed regulations (or prior guidance such as Notice 2005-1) as authority on or after January 1, 2008, except as provided in the final regulations. However, the final regulations clarify that certain provisions in Notice 2005-1 will remain applicable pending the issuance of further guidance, and Notice 2006-33, Notice 2006-79, and Notice 2006-100 will remain applicable on and after January 1, 2008.

[3] This aspect of the definition has a number of consequences for Section 409A compliance including the determination of whether a separation from service has occurred, whether a particular service provider is a specified employee, and whether the stock associated with a stock right is “service recipient stock,” among others.

[4] A point on nomenclature: We refer to deferred compensation “arrangements” throughout rather than “plans” in order to make clear that the final regulations are broadly applicable not just to traditional non-qualified deferred compensation plans but also to less obvious vehicles through which deferred compensation made be provided, including stock options, employment agreements, severance programs, and settlement agreements.

[5] The proposed regulations referred to arrangements that *in fact* provide a legally-binding right to receive compensation earned in one year in a later year.

[6] The final regulations exclude restricted property from coverage under Section 409A as long as the grant does not include any deferral features. Further, as long as restricted property is subject to a valid substantial risk of forfeiture for purposes of Section 409A, the grant of a vested right to receive non-vested property will not be subject to Section 409A. Elections between forms of compensation that are not subject to Section 409A are not themselves subject to Section 409A. However, if any of the forms of compensation at issue are subject to Section 409A, the election must comply with Section 409A.

[7] The final regulations approve as “service recipient stock” common stock that is preferred as to liquidation rights; no other preferences are permitted, although the IRS notes that future guidance may be more lenient in this area.