Hewitt

Special Report to Clients

May 2007

IRS Releases Final Section 409A Regulations

The Internal Revenue Service (IRS) has released final regulations covering the application of Section 409A to nonqualified deferred compensation plans. The long-awaited final regulations, which were published in the *Federal Register* on April 17, 2007, generally preserve the organization and overall principles of the interim guidance, but include many modifications and clarifications based on public comments. While the final regulations include numerous provisions simplifying compliance with Section 409A, significant complexities remain.

The final regulations are generally effective January 1, 2008. For the period between January 1, 2005, the statutory effective date of Section 409A, and January 1, 2008, the standards and transition rules summarized in IRS Notice 2006-79 continue to apply. Affected nonqualified deferred compensation plans and arrangements must comply with the documentation requirements by December 31, 2007, so plan sponsors have little time to review their plans and bring their design and administration into compliance.

Report Structure and Terminology
In this Special Report, Hewitt Associates provides a detailed summary of the final regulations and their anticipated impact on various nonqualified deferred compensation arrangements. An overview of the regulations is provided in the Executive Summary and the report includes a “Key Points” feature at the beginning of each major report section. The report does not cover a small number of topics that have narrow or specialized application, including partnership arrangements, indemnification arrangements, legal settlements, educational benefits, split-dollar life insurance arrangements, and collectively bargained plans.

The Section 409A regulations use the more inclusive terms “service provider” and “service recipient” to describe the parties involved in deferred compensation arrangements. In the traditional employer-employee relationship and under employer plans, the employee is the service provider and the employer is the service recipient. For simplicity, this report uses the terms “employee” and “employer” rather than “service provider” and “service recipient,” respectively. However, the rules also apply to broader service relationships, including directors and independent contractors. Also, the controlled group (using an 80% ownership threshold) rules generally apply to determine the employer, so all members of the same controlled group are essentially treated as a single employer under the Section 409A rules, unless the regulations explicitly specify otherwise (such as in the definitions of “service recipient stock” and “separation from service”).

Note: *Hewitt is not a law firm and this report is not intended to supersede or replace the need for legal advice. The review of the 409A regulations and related matters in this report is provided for informational purposes only and should not be used as the basis for making any specific legal or plan design decisions. Because of the complex nature of the rules and the numerous plan design issues raised when plan changes are required for compliance reasons, employers should engage their Hewitt consultants along with other advisers to address their unique circumstances.*

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Executive Summary

Overview of Section 409A

Section 409A was added to the Internal Revenue Code (the Code) by the American Jobs Creation Act of 2004 (P.L. 108-357). It provides comprehensive rules governing nonqualified deferred compensation arrangements and generally applies to amounts deferred in taxable years beginning after December 31, 2004. While the rules are extremely complex and subject to numerous exceptions, the primary requirements are as follows:

- Distributions cannot be made prior to one of the following:
  - Separation from service;
  - Disability or death;
  - A specified time or under a fixed schedule specified no later than the date of the deferral of compensation;
  - Change of control; or
  - Occurrence of an unforeseen emergency.
- Key employees ("specified employees") of public companies must wait an additional six months after separation from service before benefits can commence (the "six-month delay rule").
- Elections to defer most types of compensation and elections concerning form and timing of payments must be made no later than the end of the year preceding the year the related service is performed.
- The acceleration of the time or schedule of any payments is generally not permitted.
- Subsequent elections to change the form or timing of payments are allowed if:
  - The new election does not take effect until at least one year after it is made;
  - The first payment under new election commences no earlier than five years after original commencement date; and
  - The election is made at least one year prior to first scheduled payment.

The penalties for not complying with Section 409A are:

- All amounts deferred under all nonqualified plans that are of a like nature as the noncompliant plan are currently includible in gross income to the extent they are not subject to a substantial risk of forfeiture and were not previously included in gross income;

- A 20% penalty tax; and

- Penalty interest at the underpayment rate plus 1% from the date that the amount was first deferred or, if later, from the date that the amount was not subject to a substantial risk of forfeiture.

Implications of Section 409A for Common Types of Plans

This section provides a summary of the major changes that may be required for common plans subject to Section 409A.

401(k) "Mirror" Plans and Other Voluntary Nonqualified Deferral Plans

For plans that permit employees to defer compensation into a nonqualified plan, some of the major implications are:

- In most cases, employers will no longer be able to use a single deferral election covering both the qualified plan and the nonqualified plan.

- It may be difficult to use the Section 402(g) annual dollar limit on deferrals as the trigger to switch from the qualified plan to the nonqualified plan.

- Deadlines for making deferral elections and the compensation to which the deferral election applies may need to be changed.

- Employees will have fewer opportunities to elect in-service withdrawals of their contributions or to change the form and timing of distributions.

- Distribution events and related benefit commencement timing may need to be revised.

- Specified employees are subject to the six-month delay rule.

- Employers will need to balance the participant's need for flexibility with respect to the time and form of payment against the cost and complexity of keeping track of multiple payment elections.

Excess (Restoration) Plans

For nonqualified plans restoring benefits lost under a tax qualified plan because of Code limits (e.g., the Section 415 accrual limits or the recognizable pay limits), some of the major implications are:

- The common practice of distributing excess plan benefits at the same time and in the same form as the employee elects for the qualified plan must be discontinued for payments starting on or after January 1, 2008.

- Employers will need to identify newly eligible participants in a more timely fashion if they want to offer these employees an election as to the form and timing of distributions.

- Employees will have fewer opportunities to elect in-service withdrawals of their benefits and to change the form and timing of distributions (e.g., switch from a lump sum to an annuity).

- Distribution events and related benefit commencement timing may need to be revised.

- Specified employees are subject to the six-month delay rule.

Supplemental Executive Retirement Plans (SERPs)
For plans providing additional retirement benefits to executives that go beyond restoring benefits lost under the qualified plan on account of Code limits, some of the major implications are:

- The deadlines for making distribution elections may need to be changed.

- Employees will have fewer opportunities to elect in-service withdrawals of their benefits or to change the form and timing of distributions (e.g., switch from a lump sum to an annuity).

- Distribution events may need to be revised.

- Specified employees are subject to the six-month delay rule.

- Where SERPs are contained in employment agreements, more complete documentation of the arrangement may be required to demonstrate compliance with Section 409A.

Severance Plans
For plans providing severance benefits to their employees (particularly to executives who may be working under an employment agreement), some of the implications are as follows:

- Plans that pay special severance benefits for reasons other than an involuntary termination of employment (e.g., during a limited time after a change in control or if the employee quits for good reason but the good reason is not considered a materially negative change in the employment relationship) may be subject to Section 409A. However, some voluntary window programs may not be subject to Section 409A.

- Even plans that pay severance benefits only upon an involuntary termination of employment may become subject to Section 409A if the plan:

  — Provides benefits after the end of the second complete calendar year following the year in which the employee separates from service; or

  — Provides benefits that exceed two times the employee's annualized compensation (limiting that compensation to the IRS's recognizable compensation limit, e.g., $225,000 in 2007) in the calendar year before the employee separates from service, and the benefits are not paid in a lump sum qualifying for the short-term deferral exception.

- A severance plan may include payments subject to Section 409A and payments that are not subject to Section 409A. It is critical to draft plans carefully in order to minimize Section 409A exposure.

- More elaborate documentation may be required for plans (or portions of plans) subject to Section 409A.

- Employees whose severance benefits are subject to Section 409A may not be able to choose the form or timing of their severance benefits (e.g., may not be able to elect a lump sum as an alternative to pay continuation).

- Specified employees are subject to the six-month delay rule.

Voluntary Early Retirement Window Programs
For voluntary window programs providing additional pay and benefit continuation to employees who agree to retire during a window period, some of the major implications are:

- A window program may become subject to Section 409A if it:

  — Allows employees longer than 12 months to decide whether to retire;

  — Provides benefits after the end of the second complete calendar year following the year in which the employee separates from service; or

  — Provides benefits that exceed two times the employee's annualized compensation (limiting that compensation to the IRS's recognizable compensation limit, e.g., $225,000 in 2007) in the calendar year before the employee separates from service.

- Elections as to how window benefits are paid may need to be made by the deadline to elect to participate in the window program.

- For specified employees, payment of window benefits that become subject to Section 409A may be subject to the six-month delay rule.

Short-Term (Annual) Incentive Plans
Generally, annual incentive plans fall outside the scope of Section 409A provided the employer *always* makes the incentive plan payments within 2½ months following the end of the incentive plan year. If there is a risk that the employer will not always pay within this time frame, the incentive plan should be modified as needed to comply with Section 409A.

- If an employer does not do this, and a late payment occurs, then participants in the incentive plan would be subject to an additional 20% tax on the late payment and amounts deferred under other nonelective account balance plans might be subject to accelerated taxation, the 20% additional tax, and interest.

- If an employer wants the plan to conform to Section 409A, then it must specify a time for payment that is in accordance with the rules.

Long-Term (Performance) Incentive Plans
Though most long-term incentive plans may be able to avoid Section 409A altogether because payments under the plan qualify as "short-term deferrals," some will not be able to avoid Section 409A because there are points in time before the end of the performance period where a portion of the incentive is no longer subject to a substantial risk of forfeiture. Employers will need to carefully study their plans to see whether such a possibility exists, and take appropriate steps to bring their plans into compliance.

Time Vested Restricted Stock Unit (RSU) Plans
To avoid losing tax deductions under Section 162(m) or to simply promote long-term ownership of company stock without immediate taxation, employers may use RSU arrangements with payments occurring upon termination of employment. Such arrangements fall under Section 409A, and employers will need to review the various payment provisions under the plan.

- Payments to specified employees may need to be delayed.

- Accelerated payouts in the event of a change in control may need to be removed, unless the change in control event meets the requirements under Section 409A.

Executive (Taxable) Expense Reimbursement Programs
For ease of administration, many employers give executives extended periods of time after the close of a year to submit reimbursement requests for expenses incurred in that year (e.g., tax and/or financial planning programs). This causes the plan to come under the rules of Section 409A.

- Plans that provide a fixed sum of money to be spent over multiple years will need to be changed.

- Plans may also need to be changed to restrict the amount of time expenses can be submitted for reimbursement. (Generally, reimbursements must be made by the end of the tax year following the year the expense is incurred.)

Executive Employment Contracts and Ad Hoc Separation Agreements
Anytime an employment agreement provides for the possibility of payments in a future year, there is a potential for Section 409A to apply. A common example of this is where the contract provides for salary continuation in the event the executive is involuntarily terminated. Taxable expense reimbursements and special retention awards are other examples where Section 409A might come into play in an individual employment contract.

- Employers may need to revise (and in some cases renegotiate) employment contracts as well as revise memos to individuals that provide for payments in future years.

- Particular attention must be paid to features related to "good reason" terminations as well as terminations following a change in control.

Change In Control (CIC) Programs and Individual CIC Agreements

- If a CIC program is implemented after December 31, 2007, it may not be possible to accelerate payout of items that were deferred (and subject to Section 409A) prior to the program's implementation (unless the entire deferred compensation plan and like plan are terminated and cashed out in accordance with Section 409A).

- Some types of CIC events described in the plan documents may not qualify as a distribution event under Section 409A (e.g., a change in board membership that is measured over a period greater than one year).

Definition of Nonqualified Deferred Compensation

Key Points

- **Deferred Compensation:** Section 409A generally applies when an employee has a legally binding right to compensation in one year that will be paid (or may become payable) in a subsequent year (i.e., a "deferral of compensation").

- **Applicable Plans:** Section 409A applies only to plans, agreements, and arrangements that provide for a deferral of compensation.

Deferral of Compensation

Section 409A applies only to plans, agreements, and arrangements that provide for a "deferral of compensation," which generally occurs when an employee has a legally binding right to compensation in one year that will be paid (or may become payable) in a subsequent year.

Legally Binding Right

A legally binding right includes both contractual and statutory rights that are enforceable under applicable law. An employee's right to compensation generally is not legally binding if the employer retains a unilateral right to reduce or eliminate compensation for services that have already been performed. However, even if the employer has retained a right to reduce or eliminate such compensation, the employee will be treated as having a legally binding right to that compensation if the surrounding facts and circumstances indicate that the right retained by the employer:

- Does not have substantive significance; or
- Can be exercised only upon the occurrence of a specific condition.

A possible reduction or elimination of compensation attributable to normal plan operations will not extinguish an otherwise legally binding right. For example, a legally binding right to compensation can still exist even if that compensation may be reduced or eliminated though the normal operation of a plan's vesting provisions or benefit formula (including a potential reduction attributable to offsets for benefits earned under other plans).

Nontaxable Benefits

The final regulations clarify that a legally binding right to a nontaxable benefit does not create deferred compensation under Section 409A unless the employee gained the right in exchange for an amount or benefit that would be included in taxable income (other than through participation in a cafeteria plan).

Deferred Compensation Excluded From Section 409A Coverage

Key Points

- **Short-term Deferrals:** Short-term deferrals generally are not subject to Section 409A if the employee receives the payment no later than 2½ months after the end of the tax year, the payment is no longer subject to a substantial risk of forfeiture, and the payment is not linked to a date that could occur after the end of the 2½-month period.

- **Stock Options and Stock Appreciation Rights:** Nondiscounted qualified and nonqualified stock options, nondiscounted stock appreciation rights, and discounted Section 423-compliant employee stock purchase plans that use "service recipient stock" are generally exempt from Section 409A.

- **Service Recipient Stock:** Service recipient stock includes the stock of any corporation in a chain of corporations where each corporation has a controlling interest in another corporation in the chain—from the ultimate parent entity down to the entity for which the services are performed.

- **Separation Pay Plans:** A separation payment made as a result of an involuntary termination or participation in a window program is exempt *up to* two times the lesser of 1) the Section 401(a)(17) limit for the current year ($225,000 for 2007); or 2) the employee's annual rate of pay in the year prior to the separation. The separation pay exempted under this exception must be paid by the end of the second calendar year following the separation. Significantly, this means that "specified employees" who are involuntarily separated can receive limited separation pay without application of the six-month delay rule.

Certain items of compensation earned in one year and paid or payable in a subsequent year are excluded from coverage under Section 409A.

Certain Short-Term Deferrals

Certain short-term deferrals are not subject to Section 409A if:

- The employee actually or constructively receives the compensation no later than 2½ months after the end of the tax year in which the compensation is no longer subject to a substantial risk of forfeiture;

- The plan does not specify a payment date that could occur after the end of this 2½-month period; and

- The plan does not link the payment date to an event that could occur later than the end of the 2½-month period (e.g., termination, death, disability, unforeseeable emergency, or change in control).

Hewitt Comment: *Importantly, the regulations provide that payments conditioned on either an employee's involuntary separation from service or voluntary separation from service for good reason (as described in more detail later in this Special Report) are treated as being subject to a substantial risk of forfeiture under Section 409A. Accordingly, a payment made within 2½ months after the end of the year of any such termination will qualify as a short-term deferral and be exempt from Section 409A.*

Relief for Certain Installment Payments

The regulations clarify that the relief for short-term deferrals applies separately to each distribution that qualifies as a separate "payment" under the regulations. Accordingly, if a plan designates a series of installments as a series of separate payments, installment payments that will always be made before the end of the applicable 2½-month period will qualify as short-term deferrals and will not be subject to Section 409A.

Hewitt Comment: *Annuity payment forms, on the other hand, are treated as single payments under Section 409A. Accordingly, none of the individual annuity payments—including those made before the end of the applicable 2½-month period—will be exempt from Section 409A under the special exception for short-term deferrals.*

Longer Delays Permitted in Certain Situations

A payment made as soon as administratively practicable after the end of the 2½-month period will still be exempt from Section 409A as a short-term deferral if timely payment:

- Would jeopardize the employer's ability to continue as a going concern; or

- Was administratively impracticable for reasons that were unforeseeable at the time the employee acquired a legally binding right to the payment.

In addition, a payment that would otherwise qualify for the exemption for short-term deferral, but which is delayed for more than 2½ months, will still be exempt from Section 409A if all of the following are true:

- The delay is attributed to the employer's reasonable belief that a deduction for timely payment would not be permitted under Section 162(m);

- The employer could not have reasonably anticipated that the deduction would not be permitted when the employee first acquired a legally binding right to the compensation; and

- The compensation is paid as soon as practicable after it becomes deductible.

Stock Options and Stock Appreciation Rights

The regulations generally exempt nondiscounted qualified and nonqualified stock options, nondiscounted stock appreciation rights, and discounted Section 423-compliant employee stock purchase plans issued on service recipient stock. However, employee stock purchase plans of foreign employers that are not in compliance with Section 423, even where substantially all the participants are nonresident aliens, are not exempt from Section 409A. Any dividend-like rights granted in conjunction with stock options or stock appreciation rights are treated as separate arrangements from the underlying stock option or stock appreciation right and must individually meet the Section 409A regulations or otherwise satisfy an exemption.

Definition of Service Recipient Stock

For the Section 409A exemption to apply, a stock right must relate to service recipient (employer) stock.

- Service recipient stock under the final regulations generally includes *any* common stock of the employer qualifying under Section 305, irrespective of whether a different class of common stock is traded or has a higher outstanding aggregate value.

- However, common stock that contains preferential dividend treatment (outside of a liquidation preference) or certain buyback provisions does *not* qualify as service recipient stock.

- An eligible issuer of service recipient stock is defined as any corporation for which the employee performs services on the grant date and any corporation, public or private, in the chain of corporations where each corporation has a controlling interest (generally 50%, but 20% is allowed under certain situations) in another corporation in the chain (i.e., no brother-sister relationship), beginning with the parent company and ending with the corporation for which the employee performs direct services (i.e., no going "down" the chain).

- Certain corporate transactions (e.g., a spin-off) resulting in a substitution or assumption of a new or existing stock right will still qualify as service recipient stock where specified requirements are met.

Valuation

The final regulations clarify how to determine a service recipient stock's fair market value for the exercise or strike price.

- For a public company that wants to use an average over a period of up to 30 days, the company must designate the stock right recipient, the number of shares subject to the stock right, and make an irrevocable election to determine the exercise or strike price, all before the beginning of the specified averaging period.

- For a private company, the valuation method does not need to be the same for each action (i.e., one valuation method may be used to set the exercise price and a different method may be used to establish a payment amount). Regardless, there is a presumption that the valuation method used is reasonable where certain specified factors are considered.

- When using illiquid stock of a start-up corporation, the final regulations expand the safe harbor regarding an IPO or change in control and specify who can perform the valuation other than an appraiser.

Extension of Stock Right Exercise Period
The final regulations now allow an extension of a stock right exercise period in certain circumstances. An extension is allowed:

- Where the stock right is underwater on the date of the extension; or

- Where the exercise period is not extended beyond the earlier of the original term of the stock right or ten years from the date of grant.

Hewitt Comment: *Although the final regulations liberalized the rules surrounding stock options and stock appreciation rights, Hewitt recommends that a professional be consulted before any modification or corporate transaction affecting stock options or stock appreciation rights is undertaken. While the stock options or stock appreciation rights might currently be exempt, the final regulations are specific as to what changes are permitted and any slight deviation could subject the stock option or stock appreciation rights to Section 409A.*

Restricted Property
Generally, the final regulations state that a grant of restricted property will *not* constitute deferred compensation under Section 409A, even if a valid Section 83(b) election (to recognize the related income before the substantial risk of forfeiture lapses) is made. Similarly, a right to receive unvested property in a future year does not constitute deferred compensation as long as there is a substantial risk of forfeiture for purposes of Section 409A. An election between compensation alternatives (i.e., choice between restricted stock and stock options) does not violate the Section 409A election timing rules as long as there is no deferral of compensation.

Section 402(b) Trusts
Generally, the final regulations exempt transfers of a beneficial interest in or transfers to or from Section 402(b) trusts and clarify that a right to compensation mandated to be included in income under Section 402(b)(4)(A) is also exempt. However, there generally would be deferred compensation where there is a right to receive a benefit that is masked as a right to a future contribution to a Section 402(b) trust because it is similar to the right to receive property in future taxable years.

Separation Pay Plans
The following types of separation pay plans are exempt from the definition of deferred compensation:

- Collectively bargained arrangements;

- Arrangements providing separation pay due solely to an involuntary separation from service or voluntary separation under a window program;

- Reimbursement arrangements providing for expense reimbursements or in-kind benefits following a separation; or

- Foreign separation pay arrangements.

These exceptions may be used in combination to exempt pay from Section 409A. In addition, these exceptions may be used in combination with the short-term deferral exception. There is also a *de minimis* exclusion for amounts paid only on separation that do not exceed the 402(g) limit for the year ($15,500 for 2007).

However, any payment under these excepted arrangements that is a substitute or replacement for amounts deferred under another nonqualified deferred compensation plan will be treated as nonqualified deferred compensation subject to Section 409A. Separation payments made on account of a voluntary termination are presumed to be deferred compensation that is subject to Section 409A to the extent that the employee has forfeited amounts under other deferred compensation arrangements. In other cases, a facts and circumstances determination must be made.

Involuntary Separation/Window Programs

Where separation pay is due to an involuntary separation or participation in a window program, the separation pay exclusion applies if the amount and payment period are limited as described here. (See **Involuntary and "Good Reason" Separations** on p. 13 for where a separation for "good reason" may be treated as an involuntary separation.)

To come within this exception, the separation pay may not exceed two times the lesser of:

- The employee's annual rate of pay for the calendar year preceding the calendar year of separation (adjusted for any increase that was expected to continue indefinitely had there not been a separation, such as an increase in the employee's pay rate); or

- The pay cap limit under Section 401(a)(17) for the year in which the separation occurs ($225,000 for 2007).

In addition, the separation pay exempted from Section 409A under this exception must be paid by the end of the second calendar year following the separation.

The final regulations clarify that the separation pay exceptions apply *up to* the specified limits, even if the total amount of separation pay exceeds the limit and the excess becomes subject to Section 409A.

Hewitt Comment: *This is perhaps one of the most significant clarifications in the final regulations. This clarification will be particularly helpful for "specified employees"—key employees of publicly-traded companies—who are involuntarily terminated. These employees will now be able to receive separation pay, up to the limit, without application of the six-month delay rule (even if they will eventually receive additional sums after the six-month delay). Of course, the short-term deferral exception remains available and may be more flexible in some cases—such as where the separation is voluntary and the legally binding right is simultaneously provided—but payments under the short-term deferral rule are limited to 2½ months after the year of vesting.*

Reimbursements and Other Limited Payments

Reimbursements for expenses that the employee could otherwise take as a tax deduction, as well as reasonable outplacement and moving expenses (including the sale of a primary residence) actually incurred by the employee directly as a result of the separation, whether voluntary or involuntary, are treated as separation pay excepted from Section 409A. In-kind benefits provided by the employer are treated the same way if they would have been treated as separation pay had the employer reimbursed the employee rather than provided the benefits in-kind. The expenses must be incurred or the in-kind benefits must be provided no later than the end of the employee's second taxable year following the taxable year of separation.

Medical expenses reimbursed solely by the employer during the period that the employee would be entitled to COBRA continuation coverage, whether or not such coverage is elected, are also treated as separation pay. For example, the employer payment of the applicable premium for COBRA coverage will be treated as separation pay, not deferred compensation, during the COBRA continuation coverage period.

Hewitt Comment: *While these amounts are excluded from Section 409A as separation pay, plan sponsors must independently determine whether these reimbursements would be discriminatory under Section 105(h) if paid from a self-insured medical reimbursement plan.*

Reimbursements or in-kind benefits provided for longer than the specified period do not invalidate the exclusion for reimbursements and in-kind payments made during the specified period, but the extended reimbursements or in-kind benefits must satisfy the requirements of Section 409A.

Hewitt Comment: *The designation of reimbursement plans as a separate category under the final regulations is helpful as it allows for reimbursements without reducing the 2X pay limit noted above. Furthermore, specified employees need not pay these amounts and wait to be reimbursed after the six-month delay.*

Involuntary and "Good Reason" Separations

As noted, the Section 409A regulations exempt from coverage certain amounts paid over a limited time where the employee incurs an involuntary separation. (See **Defining a Separation From Service** on p. 32 for a general definition of "separation from service.")

The final regulations add a definition of involuntary separation for this and other purposes. Generally, whether or not a separation is involuntary is determined under all the facts and circumstances. There is a rebuttable presumption that the characterization by the employer and employee in their documents is presumed correct.

Conditions for Good Reason Involuntary Separations

In certain circumstances, a separation for "good reason" can be treated as an involuntary termination if specific conditions are met and the avoidance of Section 409A is not a purpose of the separation.

- Typically, these conditions must be specified in advance under the agreement to provide compensation on separation for good reason.

- The good reason must be defined to require actions taken by the employer that result in a materially negative change to the employee in the service relationship, such as the duties to be performed, the conditions under which services are performed, or the compensation received.

- Other factors taken into account include whether the amount of compensation for separation for good reason is paid at the same time and in the same form as the amount that would be paid upon an involuntary separation and whether the employee must provide notice to the employer of the existence of the good reason condition and give the employer an opportunity to correct this condition.

Safe Harbor for Good Reason Involuntary Separations
The final regulations provide safe harbor conditions which, if met, will result in the separation for good reason being treated as an involuntary separation. These conditions require the following:

- The separation must occur during a predetermined limited period of time not to exceed two years following the initial existence of one or more of the following triggering events arising without the consent of the employee:

  — A material decrease in the employee's base compensation (*Note:* This does not take into account reductions or eliminations of bonus opportunities or other short-term or long-term incentives);

  — A material reduction in the employee's authority, duties, or responsibilities;

  — A material reduction in the authority, duties, or responsibilities of the supervisor to whom the employee reports;

  — A material decrease in the budget over which the employee has authority;

  — A material change in the geographic location at which the employee must perform services; or

  — Any other action or inaction that constitutes a material breach by the employer of the agreement under which the employee provides services.

- The amount, time, and form of payment upon the separation must be substantially identical to the amount, time, and form of payment payable due to an involuntary separation, to the extent such a right exists.

- The employee must be required to provide notice to the employer of the existence of the condition described above within a period not to exceed 90 days of the initial existence of the condition. Upon notice, the employer must have a period of at least 30 days to remedy the condition and not be required to pay the amount.

Definition of Plan

Key Points

- **Plan Aggregation Rules:** Similar plans must be aggregated and treated as one plan for nearly all of the provisions of Section 409A. There are nine categories of "similar type" plans, including a division of account-based plans into elective and nonelective plans. In some cases, this subdivision may limit the impact of a failure to comply with Section 409A by isolating a failure to a plan subdivision rather than to the total account balance for all of an employee's account balance plans.

- **Plan Document Requirements:** Each arrangement subject to Section 409A must have a written plan document that may comprise multiple documents and forms.

- **Adoption of Conforming Plan Amendments:** For plans adopted and effective before December 31, 2007, Section 409A is satisfied if the plan is adopted by December 31, 2007, regardless of the year of the deferred compensation arrangement.

Plan Aggregation Rules

For most purposes under the final regulations, nonqualified deferred compensation plans of a similar type must be aggregated and treated as one plan. The types of plans are:

- Elective account balance plans (i.e., plans in which deferrals are based on the employee's election);

- Nonelective account balance plans, including matching contributions on elective deferrals;

- Nonaccount balance plans;

- Certain separation pay plans;

- In-kind benefits or reimbursements;

- Split-dollar arrangements;

- Certain foreign plans;

- Stock rights plans; and

- All other nonqualified deferred compensation plans.

The final regulations modified the proposed guidance in several areas:

- The number of categories of aggregated plans is expanded from four to nine.

- In determining what is an "account balance plan," a portion of a plan with both account balance and nonaccount balance portions must be bifurcated into a separate account balance plan if the account balance portion otherwise qualifies as an account balance plan and the amount payable under that portion is determined independently of the other portion. For example, assume a nonqualified plan has an add-on formula involving a cash balance account and a traditional defined benefit pension portion. Under the bifurcation rule, the cash balance portion may have to be treated as an account balance plan.

- Account balance plans must be subdivided into an elective part and nonelective part to the extent the amounts deferred under an elective account, including earnings, may be separately identified; otherwise, all of an employee's account balance plans are treated as one plan.

Hewitt Comment: *The subdivision of account plans into elective and nonelective plans may have advantages. For example, assume a 30-day, midyear initial election rule applies the first year the employee becomes eligible to participate in a plan. Also assume an employee becomes eligible to participate in account balance Plan A (an elective plan) in year one and eligible for account balance Plan B (a nonelective plan) in year two. Without the subdivision, the first year eligibility rule is unavailable for Plan B in year two because the employee was already eligible for an account balance plan (as applied under interim guidance where Plans A and B were aggregated one plan type). However, with the new subdivision feature, the first year eligibility rule applies in year two because that is the first year the employee is eligible for the nonelective account plan (Plan B).*

Similarly, this subdivision can limit the impact of a failure to comply with Section 409A. If all of an employee's account balance plans are treated as one, the failure of a deferral election would also impact the employee's nonelective benefits. But, where the elective plan is separate, the failure is isolated to that elective deferral portion.

On the other hand, requiring plans to be aggregated may limit the applicability of desirable provisions. *(See the examples under the* ***Limited Cashout Provision*** *section on p. 42.)*

Plan Document Requirements

Each nonqualified deferred compensation arrangement subject to Section 409A must have a written plan document.

The final regulations clarify that a plan's provisions need not be contained in a single document and may be recorded in several documents.

Hewitt Comment: *Where the plan is memorialized in multiple documents, the employer must identify the documents that include the governing plan provisions if there are conflicts with other documents such as summaries, enrollment materials, administrative guides, etc. In litigation, an employer may be challenged to demonstrate why a particular collection of documents constitutes the formal plan document. For more complicated arrangements, using multiple plan documents increases the probability of inconsistencies and gaps in required provisions.*

Required Content of Plan Document Provisions
The plan document must include the material terms of the plan on the following points:

- The amount of deferred compensation payable to the employee, which may be expressed in a formula;
- Time and form of payment;
- Conditions for making an initial deferral election, if applicable;
- Conditions for making a later election changing the form or timing of payment, if applicable;
- Six-month payment delay for payments to specified employees after a separation from service, if applicable; and
- Cashouts of small benefits, if applicable.
  - If the cashout is made at the election of the employer (vs. automatically at a certain threshold), then the employer must prepare written documentation of its decision to cash out the benefit.

Generally, the plan document need not recite the circumstances in which payments may be accelerated in accordance with Section 409A regulations (e.g., payments made pursuant to a domestic relations order or payments of federal employment taxes). However, if the plan provides for cashouts of small benefits, either automatically or at the discretion of the employer, then the plan document must include a description of the cashout rules.

Hewitt Comment: *Some employers may choose to document other circumstances, besides cashouts, in which payments of nonqualified deferred compensation may be accelerated in order to avoid contractual disputes with participants who may object to some provisions accelerating payments.*

If a plan's written provisions do not conform to the requirements of Section 409A, then the defect cannot be cured by a broad "savings clause" purporting to negate plan provisions that are inconsistent with Section 409A. Similarly, a savings clause stating that the plan is intended to conform to Section 409A does not cure the absence of a required plan provision.

Hewitt Comment: *In some ways, the plan document requirements for nonqualified deferred compensation plans are less forgiving than for tax-qualified retirement plans. For example, in some cases, the IRS prepares model amendments for changes in the rules governing tax-qualified retirement plans. The IRS has no plans to publish model amendments for Section 409A plans. Further, the IRS determination letter process allows an employer to obtain definitive approval of its documentation of a qualified plan, and the IRS may not later seek to retroactively disqualify the plan based on provisions included in an approved plan document. The IRS has no plans for a similar program to review and approve the documents for Section 409A plans.*

Also, IRS rules permit a generous remedial amendment period during which an employer may retroactively revise, many years later, the governing document for a tax-qualified plan. There is no similar provision allowing a later amendment to cure defects in the earlier documentation for a plan *subject to Section 409A. For qualified plans, the IRS's Employee Plans Compliance Resolution System (EPCRS) allows retroactive measures to cure deviations of actual administration from the terms of the plan document. Currently, there is no program for correcting such operational mistakes for 409A plans. Thus, documents for arrangements subject to Section 409A must be very carefully prepared.*

Deadlines for Adopting Written Plan Provisions
These required plan provisions must be adopted by the following deadlines:

- Generally, pertinent plan provisions may be adopted until the end of the calendar year in which the legally binding right to the deferred compensation arises. For example, a decision on December 20, 2008 to grant a SERP retirement benefit must be incorporated into the SERP plan document by December 31, 2008.

  — If the deferred compensation could not be paid in the year following the year in which the employee's legally binding right arises, then the amendment may be adopted by March 15 of the year after the year in which the legally binding right arises.

- If a plan offers employees an initial deferral election, plan provisions governing that election may be adopted until the deadline under the regulations for making the initial deferral election.

- If a plan permits employees to change earlier elections as to the form or timing of distributions, plan provisions governing those distribution election changes may be adopted until the deadline under the regulations for making the distribution election change.

- Provisions requiring the six-month delay for distributions to specified employees after separation from service must be included in the plan by the first date on which an employee is treated as a specified employee. Employers that do not currently have specified employees (e.g., privately held companies) may wish to include the six-month payment delay rule in the plan document to avoid contractual disputes in the event that the company later seeks to add that restriction to the plan at a time when it becomes applicable (e.g., when the company goes public).

- A plan amendment authorizing cashouts of small benefits must be adopted by the date on which the benefit is cashed out.

  — An employer's documentation of its discretionary decision to cash out a benefit must be prepared by the cashout date.

- A plan amendment increasing deferred compensation must be adopted by its effective date.

Hewitt Comment: *The deadlines for amending nonqualified deferred compensation plans are earlier, in many cases, than the deadlines for amending qualified retirement plans. Employers should not assume that retroactively effective amendments may be adopted in all cases.*

Special Transition Rule for Adoption of Conforming Plan Amendments
For plans adopted and effective before December 31, 2007, Section 409A is satisfied if the required written plan documentation is adopted by December 31, 2007. This deadline applies regardless of the plan year of the deferred compensation arrangement.

Hewitt Comment: *Before December 31, 2007, employers should inventory all compensation arrangements and determine which are subject to Section 409A. Plan documents, or amendments to existing plan documents, should be adopted by December 31, 2007. All required action (e.g., approval by the board of directors, execution of the document, etc.) to adopt the amendment should be completed by this date. Required provisions missing from the current plan document should be added. Existing provisions should be revised to conform to the final regulations. In some cases, there may be challenges in determining the pertinent rules for more informal deferred compensation arrangements. When drafting plan amendments, care should be taken not to materially modify provisions for grandfathered benefits, causing the loss of the grandfather. The plan amendment timing rules should be consulted to determine the date when future plan amendments should be adopted.*

Definition of Substantial Risk of Forfeiture

Key Points

- **Concept Critical to Compliance:** Understanding when a substantial risk of forfeiture exists is critical for complying with many aspects of Section 409A (e.g., election timing rules, short-term deferral exception, grandfathered amounts).

- **Identifying a Substantial Risk of Forfeiture:** A substantial risk of forfeiture exists if a payment is conditioned on the performance of substantial future services or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial.

- **Definition Specific to Section 409A:** The definition of a substantial risk of forfeiture under Section 409A is narrower than the definition under Section 83 (e.g., a non-compete condition is not a substantial risk of forfeiture under Section 409A).

Definition of Substantial Risk of Forfeiture

The final regulations generally adopt the definition of substantial risk of forfeiture set forth in the proposed regulations. Contrary to the request of several commentators, Treasury did not adopt the same substantial risk of forfeiture definition as found in Section 83 (due to differing policy concerns as well as practical differences between transfers of restricted property and promises to pay deferred compensation).

For a substantial risk of forfeiture to exist, the following conditions must apply:

- Compensation must be conditioned on the performance of substantial future services or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture must be substantial.

- A condition related to a purpose of the compensation must relate to the employee's performance for the employer or employer's business activities or organizational goals (e.g., attainment of a prescribed level of earnings or equity value).

- Both the *addition of any risk of forfeiture* (after the legally binding right to the compensation arises) and *any extension of a period* during which compensation is subject to a risk of forfeiture are disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture.

- Compensation is not considered subject to a substantial risk of forfeiture beyond the date at which the employee otherwise could have elected to receive it, unless the present value of such compensation subject to a substantial risk of forfeiture is *materially greater* than the present value of the compensation the employee otherwise could have elected to receive.

  — An election to extend the period that compensation is subject to substantial risk of forfeiture is disregarded unless the compensation subject to the election is materially greater than the amount the employee otherwise could have received.

- Compensation conditioned on an involuntary separation from service without cause may be treated as subject to a substantial risk of forfeiture if there is a substantial risk that the employee will not be involuntarily separated from service without cause.

  — Under certain circumstances, a separation for "good reason" may also be treated as an involuntary separation for this purpose.

- Compensation is not subject to a substantial risk of forfeiture merely because the right to the compensation is conditioned, directly or indirectly, upon the following:

  — Refraining from the performance of services (e.g., in accordance with a non-compete agreement); or

  — Requiring that an employee sign a release of claims in order to receive the compensation.

- A stock right is not subject to a substantial risk of forfeiture at the earlier of the first date:

  — When the holder may exercise the stock right and receive cash or property that is substantially vested; or

  — When the stock right is not subject to a forfeiture condition that would constitute a substantial risk of forfeiture.

Deferral Elections

Key Points

- **Deferral Election:** A deferral election includes both the election to defer compensation and an election as to the form and timing of the deferred compensation.

- **General Rule:** A deferral election must be made before the calendar year in which the employee performs the services for which the deferred compensation will be paid. However, a number of special deferral election timing rules apply.

- **Fiscal-Year Compensation:** A deferral election may be made until the beginning of the fiscal year.

- **Performance-Based Compensation:** A deferral election may be made up to six months before the end of the performance period if the amount payable is not readily ascertainable at that point.

- **Initial Plan Eligibility:** A deferral election may be made within 30 days after initial eligibility for the plan, subject to the plan aggregation rules.

- **Excess (Restoration) Plans:** A deferral election may be made until January 31 after the calendar year in which the employee first accrues a benefit under the plan, subject to the plan aggregation rules.

- **Certain Forfeitable Rights:** A deferral election may be made up to 30 days after the employee obtains a legally binding right to the nonvested compensation.

- **Nonelective Plans:** The employer must specify the amount deferred and the form and timing of payments by the deadline that would apply if the employee were to make a deferral election.

- **Initial Deferral Election for Certain Separation Payments:** A deferral election with respect to *ad hoc* negotiated separation payments may be made until the employee obtains a legally binding right to the payments. A deferral election with respect to deferred compensation provided under a window program may be made until the final deadline for electing to participate in the window program.

- **USERRA:** Deferral elections mandated by USERRA for service members returning from military leave may be made up to the deadline specified in USERRA.

Deferral Elections

A deferral election includes:

- An election to defer compensation, if permitted by the plan; and
- An election as to the time and form of payment of the deferred compensation, if permitted by the plan.

Both elections must be made by the deadline specified in the final regulations.

General Rule

Unless an exception applies, an employee must make any available deferral election before the calendar year in which the employee performs the services for which the compensation is paid. For example, under the general rule, an election to defer payment of a bonus paid in 2009, which is based on performance during 2008, must be made by December 31, 2007. Similarly, an election as to the time and form of payment of benefits accrued in 2008, based on 2008 compensation, must be made by December 31, 2007. A plan may permit changes in the deferral election until this deadline (e.g., the deadline for changing salary reduction elections with respect to 2009 salary payments is December 31, 2008).

Exceptions to the General Rule

The regulations include a number of exceptions that provide delayed deadlines for deferral elections in certain situations.

Deferral Election With Respect to Fiscal-Year Compensation

A special election deadline may be applied if:

- The employer has a noncalendar tax year (i.e., fiscal year);
- The deferred compensation relates to services performed during one or more whole fiscal years; and
- The deferred compensation would be paid after the last fiscal year in which the employee performs the services for which the compensation would be paid.

In this situation, the deferral election may be made until the beginning of the first fiscal year in which the employee performs the services for which the compensation is payable. For example, if an employer offers a bonus for its fiscal year beginning July 1, 2008 and ending June 30, 2009 and the bonus must be paid after June 30, 2009, then the employee may make a bonus deferral election until June 30, 2008. (Under the general rule, the bonus deferral election must be made by December 31, 2007.)

Performance-Based Compensation

The final regulations permit the initial deferral election for performance-based compensation to be made up to six months before the end of the performance period, if two requirements are satisfied:

- The employee must continuously perform services from the later of the following through the date of the initial deferral election:

  — The date on which the performance period begins; and
  — The date on which the performance criteria are established.

- The deferral election is made before the amount of the performance-based compensation is readily ascertainable. The amount of the compensation is treated as readily ascertainable:

  — If the amount of compensation is specified (e.g., $10,000) or a calculable amount (e.g., 10% of base pay), when it is first substantially certain that this amount will be paid (e.g., the performance criteria have already been satisfied); or

  — If the amount of compensation is not a specified or a calculable amount (e.g., the amount paid depends on the level of performance), when the amount that will be paid is calculable and it is substantially certain that it will be paid.

"Performance-based compensation" is compensation contingent on the satisfaction of individual or organizational performance criteria. The performance period must last at least 12 consecutive months. The performance criteria must be established in writing no later than 90 days after the performance period begins. At the time that the performance criteria are established, it must be substantially uncertain whether the employee will satisfy those criteria.

The final regulations include the following rules for determining whether a payment is performance-based compensation:

- The performance criteria do not have to be approved by a compensation committee of the board of directors or by the stockholders of the employer.

- Subjective performance criteria are allowed so long as the criteria are:

  — Bona fide and relate to the performance of the employee or a unit of which he or she is a part; and

  — The determination that any subjective performance criteria have been met is not made by the employee, a family member, or someone whose compensation is effectively controlled by the employee (or a family member).

- Compensation may be performance-based even if the amount is determined by reference to the value of the service recipient's stock (or some other measure of the value of the employer) after the award.

— If the amount of the compensation varies only because of changes in the share value, then the compensation is not performance-based. However, if the award is contingent upon a performance-based vesting requirement, then the compensation is treated as performance-based.

— Achievement of a certain stock price may be an acceptable performance criterion.

- Compensation may be considered performance-based even if it would be paid, regardless of satisfaction of the performance criteria, upon the employee's death, disability, or a change in control (as defined in the final regulations).

— However, if the compensation is paid on account of death, disability, or a change in control, and the performance criteria were not satisfied, the compensation is not treated as performance-based compensation. As a result, an initial deferral election made under the special timing rules for performance-based compensation would not be valid.

If part, but not all, of an award would qualify as performance-based compensation, then the special initial deferral election timing rule for performance-based compensation applies to that portion of the award. The performance-based portion of the award must be separately identifiable and the amount payable under that portion of the award must be determined separately.

Deferral Election in the Year of Initial Eligibility for the Plan
In the first year in which an employee becomes eligible to participate in a plan, the plan may allow the employee to make any available deferral election within 30 days after the date on which the employee first becomes eligible to participate. For example, if an employee first became eligible for a plan on May 1, 2008, the plan could allow the employee until May 31, 2008 to make an initial deferral election. (Under the general rule, the employee must make the deferral election by December 31, 2007.) For this exception, plans of the same type are aggregated and treated as a single plan. (See the **Plan Aggregation Rules** section on p. 15.)

Under this special initial deferral election rule, the deferral election must apply only to compensation paid for services performed after the election. For example, if an employee became eligible for a plan on May 1, 2008 and made an election on May 31, 2008 to defer a portion of salary for that year, then the election could only apply to salary paid for services provided after May 31, 2008. If the compensation deferred (e.g., an annual bonus) relates to a performance period (e.g., the calendar year) that begins before and ends after the initial deferral election, then the deferral election must apply only to the portion of the compensation that relates to services performed after the deferral election.

A simplifying assumption may be made that the compensation is earned ratably over the performance period so that the portion of the compensation attributable to services after the initial election is based on the ratio of the days remaining in the performance period after the election to the total number of days in the performance period. For example, if an election deferring a portion of a bonus for the 2008 calendar year were made on May 31, 2008, then the deferral election could apply to 58.36% (213 divided by 365) of the total 2008 bonus.

Hewitt Comment: *A plan's administrative system should not assume that a deferral election upon initial eligibility for the plan may apply to all compensation paid after the initial deferral election. Some of that compensation may be paid for services performed before the deferral election. For example, a portion of the salary paid for the first payroll period after the initial deferral election may relate to services performed before the deferral election. The portion of a bonus that relates to services performed after the initial deferral election must be determined based on the terms of the bonus arrangement, or the bonus must be prorated based on the number of days remaining in the performance period.*

For plans in which the employer determines the amount deferred and a portion of the amount deferred relates to services performed before the initial election by the employee as to the form and timing of benefit payments, then the employee's initial deferral election may not apply to the benefit attributable to services performed before the initial deferral election.

Initial eligibility for a deferred compensation plan occurs when the employee first accrues a benefit of any type under the plan. In the case of a plan that permits voluntary deferrals, initial eligibility occurs when the employee is first eligible to defer, not when the employee actually first elects to defer.

As noted, the plan aggregation rules must be applied to determine what constitutes the "plan" for this purpose. For example, if an excess (i.e., restoration) plan was amended to add a voluntary deferral feature midyear, then the initial voluntary deferral election could be made within 30 days of eligibility to make a voluntary deferral because the voluntary deferral part of the plan is treated as a separate plan from the nonelective restoration benefit part of the plan.

Conversely, if an employee was previously eligible for a voluntary deferral plan sponsored by another controlled group member, then this special election timing rule could not be applied when the employee later becomes eligible to participate in another voluntary deferral plan of any member of the same controlled group. This means that eligibility to participate in plans of other controlled group members may need to be monitored to determine when initial deferral elections are permitted.

If an employee loses eligibility to accrue benefits, other than earnings on previously deferred amounts, (e.g., because of a transfer or a termination of employment) and later again becomes eligible to accrue benefits (e.g., because of a transfer or reemployment), then the employee may be treated as newly eligible in either of the following circumstances:

- If the employee has received a distribution of his or her entire benefit under the plan (and all of the plans of the same type sponsored by a controlled group member) and was not eligible on or before completion of the distribution to continue to accrue benefits under the plan after the distribution, then the employee may be treated as newly eligible when he or she regains eligibility under the plan.

- If the employee has not received a distribution of his or her entire benefit under the plan (and all of the plans of the same type sponsored by a controlled group member) when the employee regains eligibility under the plan, the employee may be treated as newly eligible for the plan if at least 24 months have passed between the employee's losing and regaining eligibility for the plan.

Hewitt Comment: *Monitoring distributions from other plans in the same controlled group may be required to apply these rules, which may be particularly difficult if administration is decentralized.*

Excess (Restoration) Plans

Under the proposed regulations, plan sponsors and administrators of "excess plans" (i.e., restoration plans that provide benefits that cannot be provided under a tax qualified, 403(b), or 457(b) plan because of Code limits such as the Section 415 limit or the Section 401(a)(17) recognizable compensation limit) faced the daunting challenge of determining the exact date on which an employee first accrued a restoration benefit, triggering the 30-day initial eligibility election window.

The final regulations permit a deferral election within 30 days after the first day of the calendar year beginning after the calendar year in which the employee first accrues a restoration benefit (i.e., by January 31 of the year after the year of the first accrual). In addition, the distribution election may apply to benefits accrued with respect to compensation attributable to services performed before the initial election is made.

The new rule is helpful only if data is available to perform the calculations by January 31 of the next year. In addition, this special rule cannot be used if an employee accrued a restoration benefit in an earlier year or under another plan that must be aggregated with the restoration plan, even if the restoration benefit accrued in an earlier year has lapsed (e.g., because the Section 415 or Section 401(a)(17) limits have increased). Ensuring that a restoration benefit was never accrued in a prior year under the plan (or another plan of the same type sponsored by a controlled group member) may be very difficult or impossible.

Hewitt Comment: *Possible solutions to overcome the challenge of having new participants make timely initial elections include the following: no longer allowing automatic eligibility to such plans by requiring a formal eligibility designation to control the start of the 30-day distribution election window (however, there may be issues if the formal eligibility designation is automatic or if the plan restores benefits with respect to qualified plan accruals for a number of years before the eligibility designation); changing the plan to specify the timing and form of payment of restoration benefits; or, modifying procedures to perform the necessary calculations in time to allow elections each January.*

Deferral Election With Respect to Certain Forfeitable Rights

Special timing rules apply to the initial deferral election if the employee has a legally binding right to a benefit payable in a future year, but the benefit vests only if the employee continues to perform services for at least 12 months after obtaining the legally binding right. These timing rules are as follows:

- The initial deferral election may be made within 30 days after the employee obtains a legally binding right to the benefit, even if the benefit is based, at least in part, on services performed before the deferral election.

- The deferral election must be made at least 12 months before the earliest date on which the employee's benefit could vest. For example, if an employer awarded on March 1, 2008 an amount that would be paid on or after April 1, 2009 (but only if the employee continued to work continuously until March 31, 2009), then the employee could have until March 31, 2008 to make an election as to the form and timing of the award payment.

An employee may use this special election rule even if vesting could occur before the full 12 months of services were performed, on account of the employee's death, disability, or a change in control. However, if vesting is accelerated on account of the employee's death, disability, or a change in control, then a deferral election made under this special rule will be valid only if the election would be permitted without this special rule (e.g., the election is made before the beginning of the year in which the services giving rise to the compensation are performed). If the employee's election, under this special rule, could be negated on account of the accelerated vesting, then the plan should prescribe default rules for the form and timing of payments.

Nonelective Plans
If a nonqualified plan does not allow for elective deferrals and does not allow employees to elect the form or timing of benefit payments, then the final regulations liberalize the rules governing the time when the plan must be amended to specify the form and timing of benefit payments. The plan must be amended to specify the form and timing of benefit payments by the later of the date on which the employee first has a legally binding right to the deferred compensation or the deadline that would apply if the employee were allowed to elect the form and timing of benefit payments.

For example, a SERP that does not allow employees to elect the form and timing of benefit payments must be amended by December 31, 2007 to specify the form and timing of payments of benefits accrued in 2008.

Initial Deferral Elections for Certain Separation Payments
Where compensation is payable only on account of a voluntary or involuntary separation from service but is not excluded from coverage under Section 409A by one of the separation pay exceptions, the issue arises as to when the employee must make the initial deferral election. The final regulations provide special rules for initial deferral elections for *ad hoc* negotiated separation pay and for separation pay provided under a window program.

Ad Hoc Negotiated Separation Pay
If the employee had no prior legally binding right to the separation pay and the pay is the subject of bona fide, arm's length negotiations, the initial deferral election may be made at any time before the employee obtains a legally binding right to the payment. The special rule applies to both the employee's choice between a current or deferred payment and his or her selection of the time and form of payment of the deferred compensation. The final regulations expand this rule to apply to voluntary, as well as involuntary, separations. The exception applies to separation pay elections even if the pay is provided under a separation pay plan for which the employee was previously eligible and even if the employee was previously eligible for a separation pay plan sponsored by another controlled group member.

However, this exception is intended to address only legally binding rights created as part of the termination process and not compensation due because of previously existing legally binding rights. The exception does not apply to preexisting legally binding rights to deferred compensation, including legally binding rights that are subject to a substantial risk of forfeiture. Any change in the time and form of payments due to preexisting legally binding rights would be required to meet the rules governing subsequent deferral elections and accelerated payments.

Window Program Separation Pay
The initial deferral election for separation pay paid as part of a window program may be made up to the date on which the employee's election to participate in the window program becomes irrevocable. The window program may cover employees who terminate employment over a period of up to 12 months.

USERRA
The final regulations state that the initial and subsequent deferral election rules are deemed satisfied to the extent an employee is permitted to make such elections to satisfy the requirements of the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA). Unlike earlier guidance, the final regulations now recognize that USERRA entitles service members who are timely reemployed after a period of military leave to an opportunity to be made whole in their retirement and pension plans, including nonqualified deferred compensation plans. In nonqualified deferred compensation plans, this means that for a limited period, such employees can make new deferral elections to restore their lost deferral opportunities. Under USERRA, reemployed service members are also entitled to receive any matching contributions on their make-up contributions.

The rule that initial deferral elections must be made 30 days after eligibility is automatically satisfied for these employees. Their later elections are also deemed to satisfy the subsequent deferral election rules.

Hewitt Comment: *Employers may decide to limit reemployed USERRA employees to the same form and timing of payment they elected prior to their military leave to avoid having to calculate a two-piece benefit. The final regulations also note that employees are not terminated if they have contractual or statutory reemployment rights. USERRA gives individuals on USERRA leave reemployment rights for up to five years even if they state they do not intend to return.*

Time and Form of Payment

Key Points

- **Distribution Events:** Deferred compensation can be distributed only upon: 1) a designated event limited to the employee's separation from service, disability, or death, or upon a change in control or an unforeseeable emergency; or 2) a stated time, or pursuant to a fixed schedule, specified under the plan. Generally, a plan cannot designate more than one time or form of payment for a single, event-based payment, but there are several exceptions to this rule.

- **Date of Payment:** Employers have considerable flexibility in setting the actual payment date for payments made upon designated events. Payments not made on the date of the event will still be considered timely if the payment meets specified conditions.

- **Phased Retirement:** Employers should find it easier to accommodate "phased retirement" or "working retirement" arrangements. This is because an employee who continues to work up to half time can still be treated as having incurred a "separation from service" under Section 409A and be entitled to payments from the employer's nonqualified plan.

- **Six-Month Delay for Specified Employees:** A payment to a "specified employee" on account of separation from service generally cannot be made before six months after the employee's termination date. Employers can identify "specified employees" using simplified methods, but the same simplified method must be applied to all nonqualified deferred compensation plans. In addition, certain payments to specified employees are not subject to the six-month delay, including qualifying short-term deferrals and separation pay up to certain limits resulting from an involuntary termination.

General Rule

The final regulations provide generally that deferred compensation can be distributed only upon:

- A designated event (limited to the employee's separation from service, disability, or death, or upon a change in control or an unforeseeable emergency); or

- A stated time, or pursuant to a fixed schedule, specified under the plan.

Payments Upon Designated Events

Event-based payments are those that occur upon the employee's separation from service, disability, or death, or upon a change in control or an unforeseeable emergency.

Designating Event-Based Payments
A plan can specify different times and forms of payment for designated payment events. In most cases, these times and forms of payment must be specified in the plan before the compensation is deferred. However, if a plan is amended to specify different payment rights in the event of an employee's death or disability, or upon an unforeseeable emergency, those new payment rights can be applied to compensation deferred before the rights were added to the plan.

Importantly, a plan can specify that a payment will occur upon the earliest or latest of multiple events. A plan, however, generally cannot designate more than one time or form of payment for a single payment event, except in the following circumstances:

- For a separation from service that occurs up to two years following a change in control, an employer can designate a different time and form of payment than for other separations from service.

- For a separation from service that occurs before or after a specified date, a specified age, or specified period of service, an employer can designate a different time and form of payment than for other separations from service. This exception, however, can be used only once. For example, an employer can provide for a special time or form of payment for a termination after age 60 or a termination after completing 20 years of service—but not both.

- For payment upon the employee's disability or death, a change in control, or an unforeseeable emergency, the plan can designate different times and forms of payment, depending on whether the event occurs on or before a specified date. For example, a plan could provide for an annuity payment upon a disability that occurs on or after age 55, and a lump sum for a disability that occurs before age 55.

Hewitt Comment: *An employer can amend a plan to add payment rights in the event of an employee's death or disability, or an unforeseeable emergency, without violating the prohibition against accelerating the payment of benefits.*

Making Timely Event-Based Payments
Under the final regulations, employers have considerable flexibility in setting the actual payment date for payments made upon designated events. A payment will be treated as having been made upon a designated event if the plan provides for payment:

- On the date of the event;

- On a date that is objectively determinable and nondiscretionary as of the time of the event (e.g., one year after separation from service); or

- During a designated period that either:
  - — Begins and ends within one taxable year; or
  - — Is not longer than 90 days, provided the employee cannot designate the taxable year in which the payment will actually occur.

In addition, a payment that is not made on the date specified under the plan will still be treated as timely and as having been made on account of the designated event if the payment is made:

- As of a later date that is within the same taxable year;
- As of an earlier date that is not more than 30 days before the payment date specified under the plan (provided the employee cannot designate the taxable year of payment); or
- By the 15th day of the third month following the distribution date specified under the plan (provided the employee cannot designate the taxable year of payment).

Payments Upon a Separation From Service
Most plans will provide for payments upon an employee's separation from service.

Defining a Separation From Service
An employee incurs a "separation from service" under the final regulations if the employee and employer have a reasonable belief—based on the surrounding facts and circumstances—that the employee will either provide:

- No future services to the employer; or
- Future services at a level that does not exceed 20% of the average level of services provided by the employee during the preceding 36 months.

No separation from service occurs because of a transfer to employment with another controlled group member. For this purpose, controlled group membership is defined using a 50% ownership threshold, but an employer may elect a different ownership threshold between 50% and 80% or, based on legitimate business criteria, between 20% and 50%.

An employer can elect instead to treat employees as having incurred a "separation from service" if they will continue to provide future services at a level that does not exceed 50% of the average level of services provided by the employee during the preceding 36 months. Any election to use this alternative definition must be specified in the plan document before the compensation is deferred.

Hewitt Comment: *This provision should make it easier for employers to accommodate certain forms of phased retirement (e.g., an employee who continues to work half time can still be treated as having incurred a "separation from service" under Section 409A and become entitled to payments from the employer's nonqualified deferred compensation plans).*

The final rules clarify that the employment relationship must be treated as continuing during a military leave, sick leave, and any other bona fide leave of absence of up to six months (or any longer period during which the employee has reemployment rights that are guaranteed by contract or law). If an employee incurs a disability (as defined by regulations), the employer may treat the employment relationship as continuing for up to 29 months (instead of just six months).

In addition, in transactions involving the sale of assets from one employer to another, the buyer and seller can determine, at their discretion, whether employees who continue in their same jobs with the buyer will be treated as having experienced a separation from service.

Hewitt Comment: *This provision gives companies engaged in asset sales an opportunity to permit the continued deferral of benefits that would otherwise be paid upon a separation from service. Employees who continue in employment with a buyer in connection with a spin-off or stock sale cannot be treated as experiencing a separation from service under Section 409A. However, the rules allowing the termination and liquidation of a plan following a change in control provide employers with flexibility to pay out deferred compensation in these stock transactions if the appropriate conditions are met.*

Six-Month Delay for Specified Employees

Section 409A provides that a payment to a "specified employee" on account of a separation from service may not occur before six months after the employee's termination date (or, if earlier, the employee's date of death).

A "specified employee" is defined as any employee who:

- Is employed by a member of a controlled or affiliated service group that includes a public company (including one whose stock is traded only on a foreign exchange) as of his or her separation from service; and

- Qualifies as a "key employee" under Section 416 by satisfying any one of the following conditions:

  — The employee is among the top-paid 50 officers with compensation in excess of $145,000 (subject to annual cost-of-living adjustments);

  — The employee is a 5-percent owner; or

  — The employee is a 1-percent owner and has annual compensation in excess of $150,000.

An employee's compensation for this purpose will be determined under the general definition of compensation that applies under Section 415 unless the employer elects instead to use an alternative Section 415 definition. For the limited purpose of applying the "1-percent owner" and "5-percent owner" rules, ownership is determined with respect to the entity for which the employee provides services. The controlled and affiliated service group rules do not apply to determine an employee's ownership.

Hewitt Comment: *Multinational companies may be able to reduce the number of U.S. employees who are subject to the six-month delay by considering non-U.S. officers when identifying the group of specified employees.*

Generally, an employee's status as a specified employee is determined on December 31 (the "identification date"). An employee who qualifies as a specified employee on December 31 is subject to the six-month delay rule throughout the 12-month period that begins on the following April 1 (the "effective date").

An employer can designate a different identification date if the employer uses the same identification date for all plans. The employer can also use a different effective date for the beginning of the 12-month period, provided that:

- The selected date is no later than the first day of the fourth month following the identification date; and

- The employer uses the same effective date for all plans.

In lieu of identifying specified employees under the rules described above, the final regulations allow employers to adopt simplified methods, including the following:

- Treat all employees as specified employees who are subject to the six-month delay rule (i.e., apply the six-month delay rule to all employees).

- Apply an objectively determinable alternative method that is reasonably designed to capture all specified employees and does not result in more than 200 employees being included in the group of specified employees (e.g., all employees who have a title of vice president or higher).

An employer that chooses to identify specified employees using a simplified method must apply the same simplified method to all nonqualified deferred compensation plans.

Hewitt Comment: *If, as of January 1, 2008, an employer would like to follow a simplified method for identifying specified employees and/or use an alternative definition of compensation to identify specified employees, the employer must take necessary corporate actions (e.g., resolutions and/or amendments) by December 31, 2007.*

The final regulations also add important clarifications concerning certain payments that are *not* subject to the six-month delay. These include the following:

- **Short-Term Deferrals:** Any payments to the extent that they qualify as short-term deferrals.

- **Separation Pay:** Any payments to the extent that they qualify for the special exception for severance pay following an involuntary termination.

Payments Upon Disability
A plan may provide for payment to an employee upon his or her disability, provided:

- The employee's condition prevents him or her from engaging in any substantial gainful activity, and can be expected to last at least 12 months (or result in the employee's death);

- The employee's condition has resulted in him or her becoming entitled to income replacement benefits for at least three months under the employer's disability plan, and can be expected to last at least 12 months (or result in the employee's death); or

- The employee is determined to be totally disabled by the Social Security Administration or the Railroad Retirement Board.

Hewitt Comment: *Importantly, a plan that provides for payments upon a separation from service can make payments upon a disability that do not meet the requirements described above (provided, of course, that the employee also experiences a separation from service).*

Payments Upon a Change in Control
A plan may provide for payment to an employee upon a change in control if:

- The change in control relates to:
  - The employee's employer;
  - The corporation that is liable for the payment of plan benefits; or
  - A corporation that is a majority shareholder of the employee's employer or the corporation that is liable for the payment of plan benefits; and

- The change in control event meets one of the following criteria:
  - A person acquires more than 50% (or a higher percentage specified under the plan) of the target corporation's stock;
  - A person acquires during a 12-month period at least 30% (or a higher percentage specified under the plan) of the target corporation's stock;
  - A majority (or a higher percentage specified under the plan) of the members of the board of directors are replaced during a 12-month period; or
  - A person acquires during a 12-month period at least 40% (or a higher percentage specified under the plan) of the gross fair market value of the corporation's assets.

Payments Upon an Unforeseeable Emergency
A plan may provide for payment to an employee in the event of an unforeseeable emergency. An unforeseeable emergency is a "severe financial hardship" to the employee resulting from one of the following:

- Illness or accident of the employee or the employee's spouse, beneficiary, or dependent;
- Casualty loss affecting the employee's property; or
- Any other extraordinary and unforeseeable loss arising from events that are beyond the employee's control.

A plan can make payment upon an unforeseeable emergency only to the extent that the employee's need cannot be met through insurance reimbursements, the liquidation of other assets (but only if such liquidation would not itself cause a hardship), or by stopping deferrals under the plan. The amount of the payment cannot exceed the amount necessary to meet the need (plus any taxes resulting from the distribution).

Hewitt Comment: *The preamble to the final regulations states that assets under nonqualified and qualified plans (including loans available under qualified plans) need* ***not*** *be considered when determining whether an employee's emergency need can be relieved through liquidating other resources. The actual regulations, however, only provide that nonqualified plan assets can be disregarded for this purpose. This provision will have to be clarified by the IRS in future guidance.*

Payments at a Specified Time or Pursuant to a Fixed Schedule

A nonqualified deferred compensation plan can also make payments to an employee as of a specified time or pursuant to a fixed schedule as long as amounts payable at such times, or under such schedules, are objectively determinable and nondiscretionary at the time the compensation is deferred.

Amounts that are payable under the terms of a plan at any time during an employee's taxable year can still be treated as payable at a specified time even though the exact payment date is not specified. However, a plan may not provide for a payment to occur during a stated period that spans more than one tax year. In addition, a payment that is conditioned upon the occurrence of an event, other than a permitted event described above (e.g., the closing of a transaction), will not qualify as a payment that is made as of a specified time.

A schedule of payments will qualify as a fixed schedule under these regulations even if payments under the schedule are:

- Limited by an objective nondiscretionary formula;
- Reduced dollar-for-dollar by any Social Security benefits payable to the employee; or
- Based on the timing of the receipt of certain payments by the employer, provided certain conditions are met (e.g., an annual payment equal to a stated percentage of receivables collected during the prior year).

Special Rules for Reimbursement Plans and In-Kind Benefits
The final regulations provide greater clarity on how reimbursement arrangements or in-kind benefit programs (e.g., use of company cars or corporate aircraft) can be structured to comply with Section 409A. A reimbursement arrangement or in-kind benefit plan will be treated as providing payments as of a specified date, or pursuant to a fixed schedule, if the arrangement or plan meets all of the following conditions:

- The arrangement or plan clearly defines the expenses eligible for reimbursement or the available in-kind benefits;

- The arrangement or plan clearly defines the period during which eligible expenses will be reimbursed or in-kind benefits will be provided;

- The amount of expenses eligible for reimbursement in one year, or the amount of in-kind benefits provided in one year, will not affect the amount of reimbursements or in-kind benefits that are available in any other year (except for an overall limit that applies to a medical reimbursement arrangement);

- The reimbursement of an expense is made no later than the last day of the year following the year in which the expense was incurred; and

- The right to reimbursement or in-kind benefits may not be exchanged for any other benefit.

The final regulations also state that a plan providing for a tax gross-up payment will be treated as providing for a payment at a specified time if that tax gross-up payment is made to the employee no later than the last day of the year following the year in which the employee pays the taxes.

Delay for Payments Subject to Section 162(m)
Section 409A generally requires that payments of deferred compensation be made pursuant to a specified schedule or event. However, the final regulations generally follow the proposed regulations by permitting the employer to delay otherwise scheduled payments to the extent the employer reasonably anticipates that a deduction for an otherwise timely payment would not be allowed under Section 162(m). The payment must then be made by the employer's first taxable year during which the employer's deduction for the payment would not be barred by Section 162(m), or, if the employee separates from service, not later than the later of either:

- The end of the year in which the employee separates from service; or

- 2½ months after the employee separates from service.

The payment may be even further delayed if the employee is a specified employee in the year he or she separates from service. In this case, the payments must also observe the six-month delay rule for payments to specified employees.

Hewitt Comment: *Employers must remain particularly mindful of the proper application of the six-month delay rule in this setting. A payment delayed because of a potentially lost deduction under Section 162(m) may not have been a payment that was originally scheduled to be paid upon the* *employee's separation from service. Thus, an employer may not expect application of the six-month delay rule to apply to the payment. No matter how the payment was originally conceived, if the employer delays a payment to a specified employee due to Section 162(m) and that employee subsequently separates from service before the payment has been made, then as with other separation pay, the payment may not be made until the date six months following the date of the employee's separation from service. Careful administration of payments under a nonqualified deferred compensation plan is particularly necessary due to this Section 409A rule.*

Prohibition on Acceleration of Payments

Key Points

- **General Rules:** Plans are not permitted to accelerate payments under nonqualified deferred compensation arrangements, but there are limited exceptions, including payments made to fulfill a domestic relations order, payments necessary to avoid ethics or conflict-of-interest laws, and cashouts of deferred amounts that are less than a minimum amount.

- **Events Permitting Acceleration:** A payment made *earlier* than originally specified in the plan due to the participant's death, disability, or an unforeseeable emergency will not be treated as a prohibited acceleration provided the new payment event is specified at least one year prior to the original payment date.

- **Beneficiaries:** Beneficiaries are subject to the same prohibition on accelerations as participants.

- **Plan Terminations:** In connection with a plan termination or liquidation, a plan will be permitted to accelerate the time and form of payment if it meets certain requirements under one of three situations: bankruptcy, change in control, or company discretion.

General Rules

A nonqualified deferred compensation plan may not permit the acceleration of any payment under the terms of the plan, subject to certain limited exceptions described below. A payment (even one not otherwise subject to Section 409A) that is substituted for deferred compensation to be paid at a different time or in a different form will generally be viewed as an impermissible acceleration.

However, an impermissible acceleration does not occur if the payment is made in accordance with the terms of the plan or pursuant to a valid and timely initial deferral election as a result of an intervening permissible payment event. (See the **Time and Form of Payment** section beginning on p. 30.) For example, if the plan provides for installment payments over a fixed schedule, it is not an impermissible acceleration of payments if the plan provides that remaining payments are paid in a lump sum on the employee's death.

Exceptions to the General Rules

A plan may provide for the acceleration of a payment or may give the employer discretion to accelerate payments under certain circumstances. However, the employee may not have discretion to accelerate payments or any direct or indirect election as to whether or how the employer may exercise its discretion to accelerate payments. The plan document need not set forth the permitted exceptions, as long as the regulatory requirements are met.

The most significant exceptions to the prohibition on accelerated payments are the following:

- Payments necessary to fulfill a domestic relations order.
  - The final regulations clarify that the order need not satisfy the requirements to be a qualified domestic relations order (QDRO) applicable to qualified plans.
- Payments necessary to avoid a violation of federal, state, local, or foreign ethics or conflict-of-interests laws.
- Cashout of the employee's entire or remaining interest under the plan (or plans required to be aggregated), if the payment is not greater than the 402(g) limit (not including catch-up contributions)—$15,500 for 2007.
  - This is an increase from the $10,000 cashout limit that was provided in the proposed regulations and allows for the limit to be indexed.
- Cancellation of a deferral election upon becoming disabled or following an unforeseeable emergency or hardship distribution under the plan.
- Payments made upon a termination or liquidation of the plan under the conditions described in the **Plan Termination and Liquidation** section below.
- Payments to cover federal, state, local, and foreign income taxes upon a vesting event under a Section 457 plan (for government and certain tax-exempt employers).
- Payments to cover employment taxes.
- Payments of state, local, or foreign tax obligations.
- Payments when amounts become includible in income due to a failure to comply with Section 409A.

Multiple Payment Events

Generally, the addition, deletion, or substitution of a permissible payment event under the terms of the plan or after the initial deferral election results in a prohibited acceleration of payments if the change *could* result in the payment being made at an earlier date than would have been the case absent the addition, deletion, or substitution. However, the addition of death, disability, or an unforeseeable emergency as a potentially *earlier* alternative payment event of previously deferred compensation will not be treated as a prohibited acceleration, even if the addition results in the payment being made at an earlier time than it would have been made absent the additional payment event. Conversely, the addition of such a payment event as a potentially *later* alternative payment event generally is subject to the rules governing changes in the time and form of payment (i.e., the one-year/five-year rules).

Beneficiaries

The rules against prohibited acceleration of the payment of deferred compensation apply to payment elections by beneficiaries, as well as to the time and form elections by employees or employers. The final rules imply changing the beneficiary does not constitute an acceleration of a payment.

Plan Termination and Liquidation

A plan may permissibly accelerate the time and form of payment in connection with a termination or liquidation of the plan if it meets one of the following three conditions:

- **Bankruptcy—**The plan is terminated within 12 months of a corporate dissolution or with the approval of a bankruptcy court. Amounts deferred under the plan must be included in the participants' gross incomes in the latest of the following years (or, if earlier, the taxable year in which the amount is actually or constructively received):

  — The calendar year in which the plan termination and liquidation occurs;

  — The first calendar year in which the amount is no longer subject to a substantial risk of forfeiture; or

  — The first calendar year in which the payment is administratively practicable.

- **Change in Control—**The plan is terminated through an irrevocable action within 30 days prior to or 12 months following a change in control, provided all plans of the same type (see **Plan Aggregation Rules** section on p. 15) immediately after the change in control event are terminated and liquidated for every participant that experienced the change in control event. Participants are required to receive all amounts of compensation deferred under the terminated agreements within 12 months of the date the company takes all necessary action to terminate and liquidate the plans. If the change in control results from an asset purchase transaction, the employer with discretion to liquidate is responsible for the payment of deferred compensation.

- **Company Discretion—**The plan is terminated and liquidated at the discretion of the company provided that it meets all of the following conditions:

  — The termination and liquidation does not occur proximate to a downturn in the financial health of the company;

  — The company terminates and liquidates all plans of the same type covering the affected participants;

  — No payments in liquidation of the plan are made within 12 months of the date the company takes all necessary action to irrevocably terminate and liquidate the plan (the 12-month wait does not apply to payments that would otherwise be payable under the terms of the plan if the action to terminate and liquidate the plan had not occurred);

  — All payments are made within 24 months of the date the employer takes all necessary action to irrevocably terminate and liquidate the plan; and

— The company does not adopt a new plan of the same type at any time within three years following the date the employer takes all necessary action to irrevocably terminate and liquidate the plan.

Loss of "Top Hat" Plan Status

The final regulations provide no relief from the Section 409A rules prohibiting the acceleration of payments in order to prevent the loss of top hat plan status.

Some commentators requested that the final regulations permit an employer to cancel an employee's deferral election under, or to accelerate the payment of plan benefits from, a top hat plan to prevent an employee from participating in the plan after the employee has ceased to meet the ERISA requirements for participation in such plans. "Top hat" plans are unfunded plans primarily maintained to provide deferred compensation to a "select group of management or highly compensated employees." Plans meeting this requirement are exempt from most ERISA requirements.

The Department of Labor (DOL) takes the position that all employees participating in a top hat plan must be among the select group of employees and that participation by other employees will cause the entire plan to become subject to the ERISA requirements applicable to normal broad-based retirement plans. Some commentators were concerned that the Section 409A rules would cause a top hat plan to lose its ERISA exemption because those rules require continued participation in the plan after an employee no longer is among the select group (e.g., because of a diminution in role or reduction in pay).

If the entire plan becomes subject to the normal ERISA requirements, then the Section 409A tax penalties and other adverse tax consequences could be triggered. However, the IRS refused to include a top hat plan exception to the normal Section 409A rules, citing the lack of clarity in the pertinent requirements for top hat plans.

Hewitt Comment: *Plans subject to Section 409A that rely on the top hat plan partial exemption from ERISA will face uncertainties if employees who are no longer part of a select group continue to participate in the plan because of the Section 409A rules. It is unlikely that the DOL will issue guidance on this point soon.*

Limited Cashout Provision

Another exception to the general rule that a nonqualified deferred compensation plan cannot permit the acceleration of the time or schedule of any payment is the limited cashout provision. Plans may require (or provide employers' discretion to require) a mandatory lump-sum payment of amounts deferred that do not exceed a specified amount, provided that the payment:

- Results in the termination of the employer's entire interest in the plan (and all plans of the same type under the plan aggregation rules); and

- Does not exceed the limit on elective deferrals under Section 402(g)—$15,500 for 2007.

Unlike the proposed regulations, the final regulations do not require an employee to separate from service in order to cash out the amount. Also, the final regulations increase the maximum cashout amount from $10,000 to the Section 402(g) limit to permit cost-of-living adjustments.

Plan terms must provide for this feature. Further, any employer discretion must be evidenced in writing no later than the date of such payment.

The plan aggregation rules may restrict the ability to use the cashout provision as the following examples illustrate.

- **Example 1:** An employee is participating in elective account balance Plan A with $11,000 deferred, and elective account balance Plan B with $6,000 deferred. Assume the cashout amount in both plans is set exactly at the Section 402(g) limit. Rather than applying the cashout provisions separately to each plan, the plan aggregation rules require Plans A and B to be treated as a single plan. Here, the cashout provision does not apply in 2007, because the aggregated amount ($17,000) is greater than the Section 402(g) limit ($15,500).

- **Example 2:** Same as example 1, except the amount in Plan A is $3,000, and assume the employer wants to cash out only Plan A. Because of the plan aggregation rules, the employer may not use the cashout rule to cash out Plan A without cashing out Plan B.

Subsequent Changes in Time and Form of Payment

Key Points

- **Life Annuities:** Actuarially equivalent life annuities are treated as one time and form of payment and thus choices among such annuities can be made up until the commencement date, without engaging the subsequent deferral election rules.

- **Irrevocability of Election:** An initial deferral election is not considered made until the election becomes irrevocable under Section 409A or, if sooner, the plan's deadline. Thus, prior to the irrevocability date, an initial election can be changed.

- **Installments With Lump Sum Feature:** Installment payments may be structured in such a way as to include an immediate total distribution feature.

- **Permissible Earlier Payment Events:** Flexibility is available to plan sponsors that want to add an earlier payment in the event of death, disability, or unforeseeable emergency.

General Rules

The final regulations are consistent with the proposed regulations regarding subsequent elections to delay the time or change the form of payment of compensation previously deferred. Generally, a plan may permit a subsequent election only if the plan provides that the election:

- Is made not less than 12 months before the date a payment scheduled for a specified time or based on a fixed schedule would otherwise have been paid;

- Takes effect at least 12 months after the date the election is made; and

- Defers payment for no less than five years from the date the first payment otherwise would have been made. Elections related to payments on account of death, disability, or unforeseeable emergency are exceptions to this five-year rule.

The final rules clarify that a subsequent deferral election is not considered made until the election becomes irrevocable under the terms of the plan. Therefore, it is permissible for plans to allow changes to subsequent deferral elections anytime before the last permissible date.

Hewitt Comment: *The ability to make a subsequent deferral election is strictly optional. Many plans only permit initial elections or no elections at all. (Remember that a deferral election includes an election as to the time and form of payment, even for a plan that does not provide for elective deferrals.) If a plan decides to permit subsequent deferral elections, it must state in writing the conditions for making subsequent elections on or before the date the subsequent election is required* *to be irrevocable. For administrative ease and flexibility, a plan administrator may decide to give itself the ability to make subsequent deferral elections but not to give the same ability to employees. Because, as described below, the final rules freely permit choices among actuarially equivalent life annuities and changes in beneficiaries prior to an annuity start date, there is already some flexibility with respect to the ultimate payment form for certain employees within an initial election or mandated form of payment.*

Life Annuities

The final regulations clarify and expand the rules for treating actuarially equivalent life annuities as essentially the same payment, making it possible to permit choices among such annuities up to the commencement date. If there is a subsequent election change from a life annuity to another time or form of payment, the subsequent election must be made at least 12 months before the scheduled commencement of the annuity and must defer the commencement of payments for at least five years from the annuity's original commencement date.

The final rules elaborate on changes to an annuity form election that do not result in a subsequent deferral election:

- A change in the designated beneficiary before any annuity payment has been made; and

- A change in the form of payment before any annuity payment has been made from one type of life annuity to another type of life annuity with the same scheduled date for the first annuity payment, as long as the annuities are actuarially equivalent under the same, reasonable actuarial assumptions and methods.

Certain features can be disregarded when determining whether an annuity is treated as a life annuity, including: term certains, pop-ups, cash refunds, Social Security or Railroad Retirement leveling, and/or certain cost-of-living-features. However, such features cannot be disregarded when determining whether one life annuity is actuarially equivalent to another life annuity.

A subsidized joint and survivor annuity (JSA) may be treated as actuarially equivalent to a single life annuity (SLA) if:

- The annual lifetime annuity benefit available to the employee under the JSA is not greater than the annual lifetime annuity benefit available to the employee under the SLA alternative; and

- The annual survivor annuity benefit is not greater than the annual lifetime annuity benefit available to the employee under the JSA.

For example, an SLA that pays the employee $100 per month may be treated as actuarially equivalent to a JSA providing up to $100 per month for the employee's lifetime and $100 per month for the surviving joint annuitant.

The annuity payments must be actuarially equivalent at all times during the employee's participation in the plan. In determining whether two life annuities are actuarially equivalent, the actuarial methods and assumptions must be reasonable. This does not prevent plan sponsors from changing actuarial assumptions and methods, as long as they are reasonable during the periods they are used.

Hewitt Comment: *The final regulations provide some welcome flexibility, especially for plans that want to specify the form of payment as one or more alternative, actuarially equivalent life annuities. For example, a divorced employee who previously elected a JSA will be able to change beneficiaries or, under certain circumstances, change to a single life annuity prior to commencement date. Before permitting such changes, employers will want to review very carefully their actuarial assumptions and methods in order to avoid noncompliance with the subsequent election rules because two life annuities may not be actuarially equivalent.*

Installment Payments

Like the proposed rules, the final rules indicate that installment payments are treated as a single payment unless the plan provides otherwise. Any subsequent elections for installment payments treated as a single payment must be made at least 12 months before the installment payments were scheduled to begin, and the payment must be at least five years after that original commencement.

In contrast, if a series of installment payments are treated as separate payments, then the "one-year/five-year rule" applies to each separately identified payment. Plans are permitted to designate whether the entitlement to a series of payments is to be treated to a series of separate payments on or before December 31, 2007, as long as the provision is in writing by that date.

The final regulations provide an interesting design option by noting that a plan may permit immediate payment of all remaining installments (without causing an impermissible acceleration) if the present value of the unpaid deferred amount falls below a predetermined amount. Such a provision must specify the predetermined amount no later than the time and form of payment is otherwise required to be established. The immediate portion can be any amount, as distinguished from the mandatory cashout rule where the maximum amount is the Section 402(g) limit.

Any immediate distribution in an installment series will result in an impermissible acceleration if it is paid at the discretion of either the company or the employee, unless the payment does not exceed the amount of the Section 402(g) limit. Any change in an immediate distribution provision, including a change in the predetermined amount, is treated as a change in the time and form of payment.

Hewitt Comment: *The final rules give helpful guidance on treating an installment payment as a single payment versus separate payments for purposes of subsequent elections. They also indicate a permissible way to structure installment payments to include an immediate total distribution feature.*

Multiple Payment Events

The rules for making subsequent deferral elections generally apply to all changes in the time and form of payment—including changes resulting from the addition, deletion, or substitution of a **potential** payment event. For example:

- A plan currently pays an annuity at age 65 or, if later, installment payments upon termination. The plan wants to delete the "annuity payment at age 65" provision. This is acceptable if:

  — Once adopted, the effective date of the change is delayed for one year;

  — The change is made at least one year prior to age 65; and

— The change postpones payment until at least age 70 (five years later).

- A plan currently pays an annuity at age 65 or, if later, installment payments upon termination. If the plan wants to change the form of payment at termination to a lump sum, then the following must apply:

  — The effective date of the new election must be delayed for one year;

  — The election must be made at least one year prior to termination; and

  — The election must provide that the first payment (the lump sum) occurs five years after the termination date.

- A plan currently provides for a lump-sum payment upon separation from service. The plan wants to add a provision: “or upon a change in control.” The new timing provision is acceptable if it becomes effective no sooner than one year after being made and provides that first payment will occur upon the later of a change in control event or five years following a separation from service.

As noted earlier, the final regulations also add a potentially earlier payment in the event of death, disability, and/or an unforeseeable emergency, even if doing so results in an acceleration of payment. However, adding any of those three events as a potentially later alternative payment event must be done in accordance with the one-year/five-year rule for making subsequent elections.

Hewitt Comment: *The final regulations provide some easily available flexibility for plan sponsors that want to add an earlier payment in the event of death, disability, or unforeseeable emergency. If subsequent elections upon other events are permitted (e.g., specified date, fixed schedule, a change in control event, or separation from service), the subsequent election should be analyzed carefully to ensure it is handled in accordance with the subsequent deferral election rules.*

Domestic Relations Orders

The regulations permit an acceleration of payment and change to the time or form of payment when such a payment is reflected in or made in accordance with the terms of a domestic relations order (DRO). The permitted acceleration applies to such orders for the specified employee group (i.e., the “six-month delay” group), as well as for regular employees in a nonqualified plan. The regulations state that it is not a material modification if a plan is amended to permit payments to an alternate payee because of a DRO. Likewise, it is not a material modification if a plan that does not address the ability to make payments under a DRO simply makes such payments.

Hewitt Comment: *The provision in the final rules that a nonqualified plan may permit alternate payees to receive distributions in a different time or form than the employee is helpful. The proposed regulations had not mentioned “form.” Many DROs request rapid payment forms, such as a lump-sum distribution, and many plan administrators are willing to accommodate such requests. It is worth noting that alternate payees are treated differently from other beneficiaries. An ordinary beneficiary is subject to the usual Section 409A restrictions on the ability to change a time or form of payment that was previously elected by either the deceased employee or the beneficiary.*

Coordination of Nonqualified and Qualified Plans

Key Points

- **No Payment Link to Qualified Plan:** Effective for distributions on or after January 1, 2008, a nonqualified deferred compensation plan may no longer link the time and form of payment to qualified plan elections. This common design for excess (i.e., restoration) plans requires that crucial design decisions be made and implemented quickly.

- **Changes Under 401(k) Plans:** Changes in amounts deferred and increases in matching contributions that result from changes in elections made by the employee under a qualified 401(k) plan are allowed if certain limits are not exceeded. However, 401(k) plans sponsors are cautioned that if an employee is allowed to change what is deferred under the nonqualified plan by virtue of a change to his or her elective deferrals under the 401(k) plan, this would seem to be a violation of the "contingency benefit rule" for qualified cash or deferred arrangements.

- **Cafeteria Plan Elections:** An employee's election under a cafeteria plan is treated neither as a deferral election nor as an acceleration of payments under a nonqualified deferred compensation plan if the only impact of the cafeteria plan election is to change the amount of the employee's eligible compensation under the nonqualified plan.

- **Offsets:** Subject to certain provisions, the final regulations allow offsets of Social Security benefits, disability benefits, and small debts from nonqualified deferred compensation plans.

Linked Qualified Plans

The final regulations provide relief concerning changes in deferral elections and the prohibition on accelerated payments if these changes arise from an election (or failure to elect) by the employee or an amendment by an employer related to a subsidized or ancillary benefit under a qualified plan. This relief is also extended to certain broad-based foreign retirement plans, as discussed further in the **International Implications** section on p. 52.

Some relief is also provided where benefits under the nonqualified plan are based on the same formula as is contained in the qualified plan, but without regard to any Code limits that apply to the qualified plan, and the benefit payable from the nonqualified plan is offset by the benefit payable from the qualified plan. These plans are commonly referred to as "restoration plans," "wrap plans," or, less accurately if more than Section 415 limits are involved, "excess plans."

Hewitt Comment: *Most notably, however, as Treasury and the IRS promised in interim guidance, the transition relief for nonqualified deferred compensation plans where the time and form of payment is controlled by the time and form of payment elected by the employee under a qualified plan is eliminated for periods after 2007. As this has been a common design for these types of plans* *(as in effect prior to October 3, 2004), plan sponsors and administrators will need to move quickly to decide on alternative arrangements (e.g., whether or not to allow elections as to payment forms and, if so, which ones) so that they can determine what actions must be taken before December 31, 2007.*

Under the regulations, a *decrease* in the amounts deferred under a nonqualified plan because of increases in Code limits is not treated as a prohibited acceleration, provided that it does not change the time and form of payment under the nonqualified plan and does not exceed the change in the amount deferred under the qualified plan. Similarly, an *increase* in the amounts deferred under the nonqualified plan because of changes in the Code limits is not treated as a deferral election if the same conditions are met.

Specifically, the following actions or inactions are not treated as a deferral election or prohibited acceleration under the nonqualified plan. This is true even if the actions or inactions result in an increase or decrease, respectively, in the amount deferred provided the time or form of payment under the nonqualified plan is not changed and the change in the amount deferred under the nonqualified plan does not exceed the change in the amount deferred under the qualified plan.

- An employee's action or inaction under the qualified plan to receive a subsidized or ancillary benefit under the qualified plan (e.g., a participant's election to commence or defer a subsidized early retirement benefit under the qualified pension plan).

- The amendment of a qualified plan to add or remove a subsidized benefit or an ancillary benefit, or to freeze or limit future benefit accruals under the qualified plan (e.g., a freeze of the qualified pension plan with continuation of accruals under the nonqualified plan).

- An employee changing or not changing pretax contributions (including Roth or catch-up contributions) under the qualified plan (typically a 401(k) plan), provided that for any given taxable year, the change or lack of change does not result in an increase or decrease in the amount deferred under all nonqualified plans in which the employee participates (but not counting matching contributions) in excess of the Section 402(g) limit (increased for catch-up contributions, if the employee is age 50 or older) in effect for the taxable year in which such action or inaction occurs.

- An employee changing or not changing pretax contributions (including Roth or catch-up contributions) or after-tax contributions under the qualified plan (typically a 401(k) plan) that affects the amounts that are credited under one or more nonqualified plans as matching amounts (or other similar amounts contingent on such contributions by the employee), provided that the total of such matching or contingent amounts never exceeds 100% of the matching or contingent amounts that would be provided under the qualified plan absent any Code limits applicable to that plan.

Hewitt Comment: *There is a potential trap for the unwary here. The final regulations under Section 409A allow increases or decreases in amounts deferred and increases in matching contributions under the nonqualified plan resulting from changes in elections made by an employee under the qualified plan so long as this does not result in an increase in deferred compensation* *under all nonqualified plans of more than the Section 402(g) limit and, separately, an increase in matching contributions of more than the Section 402(g) limit or what would have been provided by the qualified plan absent Code limits.*

Plan sponsors of 401(k) plans are cautioned, however, that if a participant can change what is deferred to the nonqualified plan by changing his or her elective deferrals under the 401(k) plan, as the Section 409A final regulations would seem to permit, this may be a violation of the "contingent benefit rule" (also called the "no-conditioning rule") for qualified cash or deferred arrangements. Thus, the relief provided by the Section 409A regulations may have more limited application, such as where matching contributions are based on after-tax or other contributions not subject the rules applicable to qualified cash or deferred arrangements. In cases involving the qualified cash or deferred arrangement, 401(k) plan sponsors will probably want to have independent qualified and nonqualified plan salary deferral elections to assure that the contingent benefit rule is satisfied.

In no case may the changes applied to the qualified employer plan be allowed to change the time or form of payment for the nonqualified plan.

Changes in Elections Under Cafeteria Plans

An employee's election under a cafeteria plan is treated neither as a deferral election nor as an acceleration of payments under a nonqualified plan if the sole impact of the cafeteria plan election is to change the amount of the employee's eligible compensation under the nonqualified plan. For example, if a nonqualified plan bases deferrals on taxable compensation as reported in Box 1 of Form W-2, then an employee's election under a cafeteria plan that increases or decreases the employee's pretax salary reduction contributions for health and welfare coverage would change the amount of the employee's taxable W-2 pay and the amount of the employee's nonqualified plan deferrals, but would not be treated as a revised deferral election. The nonqualified plan must treat the change in eligible compensation resulting from a cafeteria plan election in the same manner as it would any other change in eligible compensation.

If a cafeteria plan includes a 401(k) deferral feature (e.g., excess flex credits may be contributed to the 401(k) plan), then this special cafeteria plan rule does not apply. Instead, the impact of the 401(k) election on the nonqualified plan is governed by other Section 409A rules, such as those addressing links between 401(k) deferrals and nonqualified plan deferrals.

Offsets

In addition to offsets of qualified plan benefits, the final regulations allow the following offsets from nonqualified plans:

- **Social Security Benefits:** A nonqualified plan may treat as a fixed schedule of payments a direct, dollar-for-dollar reduction of payments due under the plan by the amount of payments received or receivable as Social Security benefits. However, a plan may not permit other changes in the time and form of benefit based upon an employee's eligibility or elections related to Social Security benefits.

- **Disability Benefits:** A reduction in a nonqualified plan benefit equal to the amount receivable under an employer-sponsored disability plan generally will be treated similarly to a Social Security offset, provided that:

  — A substantial number of employees participate in the disability plan;

  — The disability plan must be established before the date the employee becomes disabled; and

  — Unless the facts and circumstances establish otherwise, any subsequent amendment to the disability plan or other change in the benefit payable under the disability plan may result in an acceleration of a payment or a subsequent deferral under the nonqualified plan.

- **Small Debts:** Payments of deferred compensation may be offset by amounts owed to the employer by the employee, where such debt is incurred in the ordinary course of the service relationship, to the extent the entire offset in any taxable year does not exceed $5,000 and the offset is taken at the same time and in the same amount as the debt otherwise would have been due from the employee.

International Implications

Key Points

- **Global Reach:** Section 409A applies to U.S. taxpayers who participate in non-U.S. plans, but the regulations provide some relief from the rules in various situations.

- **Broad-Based Foreign Retirement Plans:** A substantial portion of relief provided relates to participation in "broad-based foreign retirement plans." Unfortunately, the final regulations require that the foreign plans provide nondiscriminatory benefits but fail to define what discriminatory means in this context.

- **Treaties Prevail:** In general, amounts exempt from tax under a U.S. income tax treaty and benefits governed by a U.S. social security totalization agreement, are exempt from Section 409A.

- **Contributions Required by Foreign Law:** Compensation required to be deferred by the law of another country relating to that country's social security system or its mandatory severance pay law is generally not subject to Section 409A.

- **Linked Plans:** The relief afforded to nonqualified plans that are linked to qualified plans is extended to nonqualified plans that are linked to broad-based foreign retirement plans. However, this relief is undercut by the lack of clarity in the definition of a broad-based foreign retirement plan.

Global Application of Section 409A

From a U.S. perspective, virtually all non-U.S. plans of deferred compensation are nonqualified deferred compensation plans. Accordingly, contributions to and benefits accrued under such plans by individuals who are subject to U.S. income tax are, in principle, within the ambit of Section 409A. Persons subject to U.S. tax fall into various categories:

- U.S. citizens;

- U.S. permanent resident aliens ("green card holders");

- Resident aliens whose U.S. residence is less than permanent residence;

- Nonresident aliens; and

- Residents of U.S. territories such as Puerto Rico, Guam, Northern Mariana Islands, U.S. Virgin Islands, and American Samoa.

The regulations provide relief from the application of Section 409A in two main ways:

- By excluding certain non-U.S. plans from the definition of "nonqualified deferred compensation plan"; and

- By treating contributions to and benefits accrued under certain non-U.S. arrangements as not involving a "deferral of compensation" for Section 409A purposes.

Exclusion From "Nonqualified Deferred Compensation Plan" Definition

A "nonqualified deferred compensation plan" does not include various non-U.S. plans ("foreign plans") in specified circumstances as described below.

Treaty-Related Foreign Plans

These are plans (or other schemes, trusts, or arrangements) under which contributions or benefits for the employee are excluded from U.S. federal income tax pursuant to an income tax treaty between the U.S. and another country. This exemption is potentially helpful to all taxpayers, be they U.S. citizens, U.S. resident aliens, or nonresident aliens.

Broad-Based Foreign Retirement Plans

A broad-based foreign retirement plan is a written plan that satisfies all of the following conditions:

- The plan provides nondiscriminatory coverage (i.e., eligibility for contributions and benefits to a wide range of employees, including rank-and-file employees, substantially all of whom are nonresident aliens, resident aliens whose residence is less than permanent residence, or residents of a U.S. possession);

- The plan provides significant benefits for a substantial majority of the covered employees;

- The benefits actually provided to such covered employees are nondiscriminatory; and

- Plan provisions or governing law generally discourage employees from using the plan for nonretirement purposes or from making in-service withdrawals except in certain limited circumstances such as an unforeseeable emergency, hardship, educational purposes, or the purchase of a primary residence.

This exemption is available generally to nonresident aliens, resident aliens whose residence is less than permanent residence, and residents of the U.S. territories.

The exemption is also available to U.S. citizens and permanent residents who have nonelective deferrals under a broad-based foreign retirement plan, provided that:

- The accruals are deferrals of "modified foreign earned income" (generally, income for services performed outside the U.S.);

- The accruals under all plans of the employer do not exceed the benefit or contribution limits prescribed by Section 415; and

- The employee is not simultaneously eligible to participate in a broad-based foreign retirement plan and a U.S. qualified employer plan.

Hewitt Comment: *The addition of the requirement that benefits be nondiscriminatory is troublesome in its lack of specificity. It is not uncommon for a plan that is locally qualified, e.g., in the UK, to provide different levels of benefits to different levels of employees, with the most generous formulas being applied to the benefits of the highest paid participants. It is unclear whether such plans would fail to constitute broad-based foreign retirement plans under Section 409A simply because they fail to meet discrimination testing standards applicable to U.S. plans.*

Social Security Systems

A "nonqualified deferred compensation plan" does not include the social security system of any foreign jurisdiction to the extent benefits or contributions under the system:

- Are subject to a social security totalization agreement between that jurisdiction and the U.S.; or

- Are made to a government-mandated plan as part of the foreign jurisdiction's social security system.

Hewitt Comment*: Some countries have government-mandated plans that might or might not be viewed as being part of the jurisdiction's social security system. Query whether France's AGIRC/ARRCO system, the mandatory superannuation plans in Australia, and the mandatory defined contributions required by countries such as Chile, Hong Kong, and Singapore are part of those jurisdictions' social security systems for Section 409A purposes. We hope so, but it would be helpful if the IRS would confirm this.*

No Deferral of Compensation

A "deferral of compensation" for purposes of Section 409A does not include compensation—or earnings thereon—deferred in certain circumstances, specifically the following:

Compensation Not Taxable When It Became Nonforfeitable

A plan is not treated as providing for a deferral of compensation to the extent the compensation would have been nontaxable if it had been paid to the service provider at the time the legally binding right to the compensation became not subject to a substantial risk of forfeiture, due to one of the following:

- The compensation was excluded from gross income under the provisions of a tax treaty or other agreement to which the U.S. is a party.

- The employee was a nonresident alien at the time the compensation became nonforfeitable and the compensation would have been excluded from gross income (e.g., because it was not U.S.-sourced income).

  Hewitt Comment: *This exception will be helpful to individuals who accrued vested benefits under foreign plans before they became U.S. taxpayers. Neither those benefits nor earnings on those benefits will be subject to Section 409A restrictions.*

- The employee was a “qualified individual” for purposes of the foreign earned income exclusion under Section 911, the compensation was for services outside the U.S., and the compensation did not exceed the unused portion of the maximum exclusion amount ($82,400 for 2006) for foreign earned income for that year.

- The compensation was for an employee of a foreign government or an international organization.

- The compensation would have qualified as excludible income from sources within Guam, American Samoa, the Northern Mariana Islands, or Puerto Rico.

Limited Deferrals of Nonresident Aliens
If a nonresident alien accrues deferred compensation under a foreign plan with respect to services performed in the U.S., the amounts deferred under the foreign plan will not be treated as a deferral of compensation under Section 409A if they do not exceed the applicable dollar amount under Section 402(g) for the taxable year—$15,500 for 2007.

For this purpose, a foreign plan is a plan maintained for a substantial number of participants substantially all of whom are nonresident aliens or resident aliens whose residence is less than permanent residence.

Tax Equalization Agreements
“Deferral of compensation” does not include compensation paid under a tax equalization agreement (i.e., an arrangement intended to compensate an employee for an increase in taxes resulting from cross-border employment) if:

- The amount paid does not exceed the excess taxes resulting from the cross-border employment; and

- Payments under the tax equalization agreement are made no later than the end of the second taxable year beginning after the later of the year in which the employee’s U.S. federal income tax return is required to be filed or the year in which the employee’s foreign tax return (or tax payment) is required to be filed (or made).

Foreign Separation Pay Plans
Separation or severance pay, whether due to involuntary or voluntary separation, is not deferred compensation for purposes of Section 409A to the extent that:

- It is required to be provided under the law of a foreign jurisdiction; and

- It relates to foreign earned income as defined in Section 911 (as modified by the final Section 409A regulations) without regard to the requirement that the amount be received before the close of the taxable year to which the relevant services relate.

Linked Plans

Where a nonqualified deferred compensation plan is linked to a broad-based foreign retirement plan, the regulations provide the same relief as for nonqualified plans linked to qualified plans. (See the **Linked Qualified Plans** section on p. 48.)

Hewitt Comment*: While it is normally easy to ascertain whether a plan is a qualified plan, it can (as previously stated) be difficult to determine whether a given foreign plan meets the regulations' definition of broad-based foreign retirement plan. This can be troublesome because if a foreign plan linked to a nonqualified U.S. plan fails to qualify as a broad-based foreign retirement plan, the linkage of the two plans could cause the U.S. plan to violate Section 409A.*

Offshore Funded Plans

As indicated in the **Outstanding Guidance** section on p. 64, the final regulations do not address the treatment of offshore funded plans. These issues are left to future regulations.

Short-Term and Long-Term Incentive Arrangements

Though not unique to non-U.S. situations, Section 409A applies to incentive arrangements that do not qualify under the short-term deferral exception. Wherever U.S. taxpayers are involved in a non-U.S. incentive arrangement, the plan should be carefully reviewed to determine whether or not Section 409A applies.

Stock Rights

Granting discounted stock options in the U.S. has been virtually eliminated by the enactment of Section 409A and government investigations of backdating stock option scandals. Option grants and other stock award practices outside the U.S., however, may still create issues under Section 409A. For example, an all-employee discounted stock purchase plan that does not meet the requirements of Section 423 can result in a violation of Section 409A. Here, too, caution should be exercised where U.S. taxpayers participate in stock right programs outside the U.S.

Transition and Effective Date

Key Points

- **Amounts Subject to Section 409A:** Generally, Section 409A applies to amounts deferred after 2004 and amounts deferred on or before December 31, 2004, if the amounts were not earned and vested as of that date.

- **Grandfathered Amounts:** Amounts earned and vested on or before December 31, 2004 (and related earnings after that date), can be "grandfathered" (i.e., not required to comply with Section 409A) unless the underlying plan is materially modified after October 3, 2004.

- **Tracking of Grandfathered Amounts:** Plans need to separately track grandfathered amounts only if they do not want to apply the Section 409A requirements to those amounts.

- **Material Modifications:** Material modifications after October 3, 2004 to plan provisions governing grandfathered benefits generally will cause these benefits to become subject to Section 409A, but the final regulations provide some exceptions.

- **Effective Date of Final Regulations:** The final regulations become effective January 1, 2008. Existing plans that are subject to Section 409A must be in compliance with a written plan by January 1, 2008. Any required amendments will need to be adopted by December 31, 2007, regardless of plan year.

- **Initial Deferral Elections:** Deferral elections made prior to January 1, 2008 that comply with the final regulations or are in good faith compliance with the transition guidance will be deemed in compliance, even if the period of deferral extends beyond January 1, 2008.

Earned and Vested Amounts

The final regulations generally adopt the rules from the proposed regulations concerning an amount deferred on or before December 31, 2004. An amount is considered deferred before January 1, 2005, if before January 1, 2005, the employee had a legally binding right to be paid the amount, and the right to the amount was earned and vested. A right to an amount is earned and vested only if the amount is not subject to a substantial risk of forfeiture or a requirement to perform further services.

A stock option, stock appreciation right, or similar compensation that on or before December 31, 2004, was immediately exercisable for cash or substantially vested property is treated as earned and vested, regardless of whether the right would terminate if the employee ceased providing services for the employer.

The final regulations clarify that the grandfathered amount includes any account balance that is earned and vested, as well as the present value of any earned and vested right to future account credits, even if such amounts had not been credited to the account as of December 31, 2004. For example, if an employee had a vested right on December 31, 2004, to have a contribution added to the employee's account balance in a nonqualified plan, the employee's grandfathered amount would include the amount of such contribution even though such amount was not calculated and credited to the account until some time in 2005.

Calculation of Grandfathered Amount Not Subject to Section 409A

Section 409A applies to all deferrals that become earned and vested after December 31, 2004 and to earnings on those amounts after December 31, 2004. Section 409A also applies to deferrals that are earned and vested by December 31, 2004 if the plan is "materially modified" after October 3, 2004. The calculation of the grandfathered amount not subject to 409A is described below. Plans need to determine a grandfathered amount only if they do not want to apply the 409A requirements to those amounts.

General Rule

An amount is considered deferred before January 1, 2005 (grandfathered) if the participant has a legally binding right to be paid the amount, and the right to the amount is earned and vested, i.e., not subject to a substantial risk of forfeiture (as defined under Treasury Regulations Section 1.83-3(c)) or a requirement to perform further services.

Account Balance Plans (As Defined Under FICA Rules)

The grandfathered amount equals the portion of the account balance as of December 31, 2004 that is earned and vested, plus any future credits to the account that were earned and vested as of December 31, 2004, but only if such credits are actually made, plus any earnings after 2004 on the grandfathered amount.

Nonaccount Balance Plans (As Defined Under FICA Rules)

The grandfathered amount equals the present value of the amount the participant would be entitled to under the plan if the participant voluntarily terminated services without cause as of December 31, 2004 and received their entire benefit from the plan as of the earliest possible date in the form with the maximum value.

- After December 31, 2004, the grandfathered amount may increase to equal the present value of the benefit to which the participant actually becomes entitled, in the form and at the time actually paid, determined under the terms of the plan (including applicable limits under the Code), as in effect on October 3, 2004. This is without regard to any service by the participant after December 31, 2004 or any other events affecting the amount of or the entitlement to benefits (other than a participant election with respect to the time or form of an available benefit).

- The present value of the grandfathered amount must be determined using reasonable actuarial assumptions and methods at all times. Reasonable assumptions chosen as of December 31, 2004 will continue to be considered reasonable thereafter for purposes of calculating the grandfathered amount. Assumptions and methods will be presumed reasonable if they are also used for a qualified plan coordinated with the nonqualified plan.

- Plan aggregation rules do not apply for choosing reasonable assumptions, so separate plans can use different assumptions. However, the assumptions must be reasonable.

Equity Based Compensation
The grandfathered amount is determined using the rules for account balance plans above, except that the account balance is deemed to be the amount of the payment available to the participant on December 31, 2004 (or what would be available to the participant if the right were immediately exercisable), which is earned and vested as of December 31, 2004. For this purpose, the payment available to the participant excludes any exercise price or other amount that must be paid by the participant.

Earnings
Grandfathered amounts include earnings. For nonaccount balance plans, earnings include the increase, due solely to the passage of time, in the present value of the amounts deferred under the plan before January 1, 2005. Thus, for each year, there will be an increase resulting from the shortening of the discount period before the future payments are made, plus, if applicable, an increase in the present value resulting from survivorship during the year.

Bonus Issue
The inclusion of benefits accrued as of December 31, 2004 attributable to a 2004 bonus payable in 2005 will depend upon the specific plan provisions of the defined benefit plan and incentive plan. For example, if the incentive plan requires the participant to be active as of the bonus payment date to be entitled to the bonus and for the defined benefit plan to include the payment in 2004 plan compensation, then the benefit attributable to the bonus would not be "earned" as of December 31, 2004. Similarly, a bonus payment attributable to services performed during 2004 and subject to board approval (where such approval is not perfunctory) might not be included in the calculation of the grandfathered amount if the approval occurs after December 31, 2004.

Frozen Plans
Plans that froze benefit accruals on or before December 31, 2004 may still be impacted by Section 409A if any participants had nonvested benefits or may earn early retirement subsidies for additional service after December 31, 2004.

Material Modifications

Amounts deferred before January 1, 2005 are subject to Section 409A if the plan is materially modified after October 3, 2004. A plan is treated as materially modified if either of the following occurs:

- A benefit or right existing as of October 3, 2004 is materially enhanced and the enhancement affects amounts earned and vested before January 1, 2005—it does not matter that the enhanced benefit or right would be permitted under Section 409A; or

- A new material benefit or right is added for amounts earned and vested before January 1, 2005.

The material modification may result from either of the following:

- A plan amendment adopted by the employer (e.g., amending the plan to allow “haircut” withdrawals of grandfathered amounts); or

- The employer’s exercise of discretion under the prior terms of the plan (e.g., exercising discretion permitted under the plan to accelerate vesting of a benefit to a date before January 1, 2005).

  — However, a material modification does not occur if an employer exercises discretion permitted under the terms of the plan, as of October 3, 2004, to change the time and manner of payment of a benefit.

Hewitt Comment: *When amending a plan to comply with Section 409A, care should be taken to avoid changes in the rules for grandfathered deferrals, leading to a loss of their grandfathered status and subjecting those deferrals to the requirements of Section 409A. In many cases, plan documents will become more complicated because they will contain different sets of rules for grandfathered and nongrandfathered benefits.*

The final regulations permit certain changes to grandfathered benefits that are not treated as material modifications and do not result in loss of grandfathered status. The final regulations carryover the exceptions in the proposed regulations and add several new exceptions.

Hewitt Comment: *Many nonqualified plans include provisions prohibiting cutbacks in plan benefits and rights. Before amending a plan to reduce rights with respect to grandfathered amounts, employers should ensure that there are no contractual barriers to the amendment.*

The following are not treated as material modifications under the final rules:

- An employee’s exercise of a right (e.g., the right to revise an earlier distribution election) provided under the plan, as in effect on October 3, 2004;

- A reduction of a benefit (e.g., the elimination of a “haircut” withdrawal right);

- Adding a Section 409A compliant cashout feature;

- Compliance with a domestic relations order that requires payments to someone other than the employee;

- Adding additional actuarially equivalent life annuity forms of payment and allowing employees to choose between the actuarially equivalent annuity options;

- Establishing or contributing to a trust fund or other funding arrangement for plan benefits, if this funding arrangement would not otherwise result in taxation for the employee (e.g., a rabbi trust may be established to fund grandfathered benefits);

- Revising a plan provision requiring the *immediate* cessation of deferrals (e.g., after a haircut withdrawal of grandfathered amounts) to requiring a delayed cessation of deferrals, for an equivalent time period, beginning on the earliest date on which Section 409A is not violated. (This exception is needed because Section 409A only permits a cessation of deferrals after unforeseeable emergency withdrawals and 401(k) hardship withdrawals, but not after many other types of distributions);

- Freezing or terminating a plan, pursuant to authority provided under the plan, so long as employees are not permitted to elect whether or not to end their participation in the plan;

- Changing (or adding to) an existing investment measure used to determine earnings for an account balance plan by substituting (or adding) an investment measure based on the returns of specified investments (e.g., the return on a specified mutual fund) or another measure that provides a reasonable rate of interest; and

- Modifying, extending, or renewing a stock right where that change would not be treated as the grant of a new stock right or the inclusion of a deferral feature from the date of the original grant.

Generally, adopting a new plan or granting a new benefit under an existing plan after October 3, 2004 and before January 1, 2005 is presumed to be a material modification unless the plan adoption or grant is consistent with the employer's historical compensation practices. However, if a plan is amended after October 3, 2004 and before January 1, 2005 to defer additional compensation and the additional deferrals are designated as being subject to Section 409A, then only those new deferrals become subject to Section 409A; earlier deferrals retain their grandfathered status and are not subject to Section 409A.

The final regulations retain a safety valve to avoid inadvertent loss of grandfathered status through a material modification to grandfathered benefits. If a plan is inadvertently modified to materially modify grandfathered benefits, then the modification may be rescinded, preserving the grandfathered status of those benefits. The modification must be rescinded before the end of the calendar year in which the change was made and before any discretionary right granted by the modification is exercised.

The final regulations clarify that compliance with Section 409A is only required prospectively when plan provisions governing grandfathered benefits are materially modified, causing those benefits to become subject to Section 409A. If a plan is materially modified after October 3, 2004 with respect to amounts deferred before January 1, 2005, then the plan's compliance with Section 409A with respect to these deferrals is determined based on the materially modified provisions of the plan and the actions taken on or after the date of the material modification.

For example, if a grandfathered benefit is materially modified after 2007 to give participants an election as to the time and form of payment, the election would have to comply with the one-year/five-year subsequent election rules (as well as the rest of the Section 409A requirements). The material modification of plan provisions relating to the formerly grandfathered benefits does not violate Section 409A, even if such a plan amendment would not be permitted with respect to nongrandfathered benefits. Similarly, actions taken before the material modification, in accordance with provisions in effect before the plan is materially modified, are not taken into account in determining compliance with Section 409A.

Effective Date of Final Regulations

Existing Transition Relief

One of the pleasant surprises under the final regulations was the flexibility offered in either applying the good faith interpretation allowed in earlier guidance or relying on the final regulations. The initial guidance provided under the proposed regulations and IRS Notice 2005-1, plus the extensions and clarifications to that guidance under Notices 2006-4, 2006-33, 2006-64, and 2006-79, may continue to be relied upon as they apply to affected arrangements. Note that this good faith reliance does not apply to discounted stock options that were backdated.

Application of Final Regulations

The final regulations are generally effective January 1, 2008. Existing deferred compensation plans that are subject to Section 409A must be in compliance with a written plan by January 1, 2008. Any required amendments will need to be adopted by December 31, 2007. Plans that rely on published transition rules need not adopt written amendments reflecting the transition rules and operations as long as the employer can demonstrate that the plan was operated in compliance with the transition guidance.

Stock Rights

The final regulations do not adopt a general exclusion for all stock rights issued prior to the final regulations. However, for stock rights issued before January 1, 2005, Notice 2006-4 provides relief with respect to options where the stock right exercise price was set below the actual fair market value on the date of grant but there was a "good faith" attempt to set the exercise price at or above fair market value. For stock rights issued on or after January 1, 2005 and prior to January 1, 2008, relief is also provided (under Notice 2005-1), but the fair market value must be determined using a reasonable valuation method. Regardless, any stock rights issued prior to January 1, 2008 will be in compliance if the issuer relies on the provisions of the proposed or final regulations with regard to determining the fair market value of the underlying stock.

Considering that the final regulations drastically expand the permitted modifications and extensions of stock rights, issuers may rely on the final regulations for any period before January 1, 2008. Likewise, any stock right modification or extensions occurring prior to the enactment of Section 409A (October 23, 2004) will be excluded from coverage under Section 409A, and any stock right extension arranged to provide solely for an additional exercise period granted prior to April 10, 2007 is disregarded.

Initial Deferral Elections

Deferral elections made prior to January 1, 2008 that comply with the final regulations or are in good faith compliance with the transition guidance will be deemed in compliance, even if the period of deferral extends beyond January 1, 2008. Also, in the situation where an employer's program was established prior to April 10, 2007 and, in good faith compliance, allowed for an initial deferral election after December 31, 2007 and on or before December 31, 2008, it will be deemed to be in compliance provided the election is made by the plan's deadline. If such a plan, in good faith reliance on the guidance, would have allowed an election after December 31, 2008, it will be deemed to be in compliance only if the election is made by December 31, 2008.

Designation of Time and Form of Payment

Notice 2005-1 and the preamble to the proposed regulations provide detailed transition guidance, generally permitting employers and employees to change the time and form of payment at any time through the end of the transition period provided the change does not result in payment being accelerated into the year the change is made or result in a delay in payment to a year beyond the year the change is made. Any changes made in accordance with the transition relief will be considered initial elections with respect to the time and form of payment (thus avoiding some of the onerous provisions of subsequent elections or noncompliance penalties associated with accelerating a payment).

Outstanding Guidance

Key Points

- **Reporting and Withholding Requirements:** The reporting and withholding requirements applicable to compensation subject to Section 409A will be addressed in future guidance.
- **Other Issues:** Other issues under consideration include offshore trusts with financial health triggers, independent contractor representations, and preferential rights of service recipient stock.

Calculation and Timing of Income Exclusion Amounts, Reporting, and Withholding

The final regulations do not address the calculation and timing of amounts required to be included in income under Section 409A, nor do they address the reporting and withholding requirements applicable to employers that provide nonqualified deferred compensation covered by Section 409A. The Treasury and the IRS intend to issue further guidance on these issues. Plan sponsors may refer to IRS Notice 2006-100 (Internal Revenue Bulletin (IRB) 2006-51 1109, *Reporting and Wage Withholding Under Internal Revenue Code Section 409A*) for transition rules applicable to the reporting and withholding requirements for 2005 and 2006.

Offshore Trusts and Arrangements With Financial Triggers

The final regulations do not address the application of Section 409A(b), which generally prohibits the use of offshore trusts associated with nonqualified plans and the use of triggers that restrict payments of deferred compensation amounts in connection with a change in the financial health of the employer. Plan sponsors may refer to Notice 2006-33 (IRB 2006-15 754) for guidance related to the application of Section 409A(b).

Leave Programs and Compensatory Time Plans

The final regulations do not address when a leave program will be treated as a bona fide sick leave or vacation leave plan for purposes of Section 409A, nor do they clarify the definition of a compensatory time plan. Until further guidance is provided, plan sponsors may rely on the definitions of bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan applicable for purposes of Section 457(f) as also being applicable for purposes of Section 409A.

Independent Contractor's Representation

The Treasury and IRS indicated that they are still studying the request made by commentators that a service recipient be allowed to rely upon the representation of an independent contractor that he or she qualifies for exclusion under Section 409A, so that the service recipient will know whether it is subject to Section 409A with respect to remuneration of the independent contractor.

Preferential Rights of Service Recipient Stock

The final regulations do not treat any stock that provides preferential rights, other than liquidation rights, as service recipient stock. However, the final regulations authorize additional guidance on this issue in the event a workable standard under which permissible standards can be distinguished from impermissible preferences.