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IRS ISSUES PROPOSED REGULATIONS UNDER CODE SECTION 409A COVERING NEW DEFERRED COMPENSATION RULES

October 17, 2005

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This memorandum summarizes the provisions of the Proposed Regulations issued under Section 409A of the Internal Revenue Code (the "Code") and published in the Federal Register on October 4, 2005 with respect to the new deferred compensation rules that were enacted last year.[1] The Proposed Regulations are not intended to be comprehensive, but do address many of the issues raised by the statute and by the Treasury Department's earlier guidance – Notice 2005-1.

Because the Proposed Regulations will not become effective, as discussed below, until January 1, 2007, in the near term their primary significance may be that (i) they extend some – but not all – of the transitional relief provisions that were originally contained in Notice 2005-1, as further discussed below, and (ii) they articulate rules upon which sponsors of and participants in deferred compensation arrangements may rely until the Proposed Regulations become final.

A. EFFECTIVE DATE; TRANSITION RULES.

1. ***Effective Date of Regulations; Coordination of Proposed Regulations with Notice 2005-1***. The Proposed Regulations are not scheduled to become effective prior to 2007. Accordingly, (1) nonqualified deferred compensation plans are not required to comply with the Proposed Regulations (or the final regulations once they are issued) until such effective date and (2) the application of certain transition relief contained in Notice 2005-1 has been extended through December 31, 2006. Until the Proposed Regulations or other future guidance under Section 409A becomes effective, taxpayers may continue to rely on Notice 2005-1. However, the Treasury Department ("Treasury") has advised that reliance on either the Proposed Regulations, read consistently with Notice 2005-1, or the final regulations (once issued), will constitute good faith compliance with Section 409A. To the extent that a provision of the Proposed (or final) Regulations is inconsistent with a provision of Notice 2005-1, a plan may comply with the Proposed (or final) Regulations in lieu of the corresponding provision in Notice 2005-1.

2. ***Transition Relief <u>Not</u> <u>Extended</u>***. The following transition relief provisions of Notice 2005-1 have <u>not</u> been extended under the Proposed Regulations:

[1] Our October 28, 2004 and February 11, 2005 memoranda addressing Section 409A generally and the previously issued Notice 2005-1 can be found at http://www.simpsonthacher.com/content/publications/pub479.pdf and http://www.simpsonthacher.com/content/publications/pub498.pdf, respectively.

(a) *Initial Deferral Elections*. Notice 2005-1 allowed service providers to make initial deferral elections on or before March 15, 2005 with respect to deferred amounts relating in whole or in part to services performed by December 31, 2005. This March 15, 2005 deadline with respect to deferrals of 2005 compensation has not been extended. Moreover, the Proposed Regulations do not extend the statutory deadline for making initial deferral elections in respect of compensation to be earned in 2006. Therefore, any such deferral elections for 2006 compensation should generally be made no later than December 31, 2005 (unless the compensation qualifies as "performance-based" within the meaning of Section 409A, or otherwise qualifies for special treatment as described below in D. "Initial Deferral Election Requirements").

(b) *Cancellation of Deferrals or Termination of Plan Participation*. Notice 2005-1 allows a plan adopted before December 31, 2005 to be amended to grant its participants the right to either (1) cancel any outstanding deferral elections with respect to amounts under the plan that are subject to Section 409A or (2) terminate participation in the plan, so long as (i) the plan amendment is effective by December 31, 2005 and (ii) the amount subject to the canceled election or termination or participation is includible as income to the participant in calendar year 2005 or, if later, the taxable year in which such amounts are earned and vested. The period during which a plan may be amended to allow participants to cancel a deferral election or terminate participation in a plan has not been extended beyond December 31, 2005.

(c) *Termination of Grandfathered Plans*. Notice 2005-1 permits the amendment of certain "grandfathered" deferred compensation arrangements to terminate such plans and distribute the amounts accrued thereunder, without triggering a "material modification" that would subject such plans to Section 409A, so long as (1) the amendment to terminate the grandfathered plan is made by December 31, 2005 and (2) the deferred amounts under the plan will be fully paid out in the same taxable year as the year of plan termination. The period during which a grandfathered plan may be so amended and terminated without subjecting the plan to Section 409A has not been extended beyond December 31, 2005.

3. ***Transition Relief <u>Extended</u> through December 31, 2006***. Set forth below are those provisions of Notice 2005-1 that have been extended through December 31, 2006 under the Proposed Regulations. Note that in order to take advantage of the transition relief, plans subject to Section 409A must be operated in good faith compliance with Section 409A at all times.

(a) *Plan Amendments – Documentary Compliance*. Existing plan documents must be amended by no later than December 31, 2006 either to comply with Section 409A or to cause the plans to no longer be subject to Section 409A.

(b) *Plan Amendments – Changes in Payment Elections*. Plans may be amended to allow service providers, prior to December 31, 2006, to make new payment elections (both as to time and form of payment) with respect to previously deferred amounts, without regard to the normal limitations under Section 409A with respect to election changes. However, after December 31, 2005, service providers cannot change their elections either (1) with respect to amounts that would otherwise be payable in 2006 or (2) to cause amounts to be payable in 2006 that would not otherwise be payable in 2006.

(c) *Payment Elections Linked to Tax Qualified Plans.* Payment elections under nonqualified deferred compensation plans such as "excess benefit" or "wrap" plans that are controlled by reference to elections made under a tax-qualified plan pursuant to its terms as in effect on October 3, 2004 may be honored with respect to distributions occurring or commencing (in the case of installment payments) before January 1, 2007, without regard to the normal limitations on elections applicable under Section 409A.

(d) *Corrective Actions – Stock Options and Stock Appreciation Rights*. During 2006, stock options or stock appreciation rights (SARs) that might otherwise be subject to Section 409A (e.g., a stock option or SAR having a discounted exercise price as of the grant date) may be canceled and replaced with stock options or SARs having terms that would cause such awards not to be subject to Section 409A (e.g., by increasing the exercise price to equal the grant date value of the stock underlying the award), so long as the replacement option or SAR is not exercised or otherwise canceled in exchange for cash or other vested property during 2006. Treasury has suggested compensating holders of such options or SARs for the lost discount element of their cancelled options or SARs by either (1) paying, in 2005, the amount of the discount in cash to such holders (note, however, that such payment would not be permitted in 2006 for options canceled in 2006) or (2) granting restricted stock or a separate deferred compensation award having a value equal to such lost discount, subject to the same vesting schedule as the original option or SAR; so long as, if such grant occurs during 2006, vesting occurs no sooner than 2007.

B. SCOPE OF SECTION 409A.

1. ***General***. The Proposed Regulations reiterate the broad application of Section 409A to any arrangements that effectively provide for the deferral of the receipt by a service provider of compensation. As we noted in our February 11, 2005 memorandum, the definition of "deferred compensation plan" for purposes of Section 409A may include many arrangements that are not typically thought of as "deferred compensation plans" in the traditional sense, such as:

- annual or multi-year bonus plans with deferred payouts;
- "in-the-money" stock option or "in the money" SAR grants;
- awards of restricted stock units and other similar phantom equity awards with deferred payments or settlement dates beyond the vesting date; and
- certain severance arrangements.

The Proposed Regulations do, however, (1) reiterate the exemption of certain specified welfare benefit plans and tax-qualified pension arrangements from Section 409A and (2) add new exemptions from Section 409A covering non-U.S. plans that are governed by international tax treaties and certain other non-U.S. broad-based retirement plans.

2. ***Short-term Deferrals (2½ Month Rule Exception)***. The Proposed Regulations expand upon the short-term deferral exception to Section 409A that was initially proposed under Notice 2005-1. Under this exception, compensation that is paid within 2½ months after the end of the calendar year or relevant fiscal year in which the service provider's right to the compensation becomes vested (i.e., no longer subject to a substantial risk of forfeiture) will not be subject to Section 409A. For example, the 2½ month rule will generally exempt from Section 409A an annual or long-term bonus plan under which the employee's right to the bonus vests on December 31 of a particular year, so long as the bonus is paid to the employee by March 15 of the following year.

The Proposed Regulations clarify that it is not necessary for an arrangement intended to qualify for the 2½ month rule to provide in writing that payment will be made by the relevant deadline, so long as the payment is in fact made before the end of the 2½ month period. However, the Proposed Regulations caution that, in the absence of a written fixed payment date, the failure to make a payment within the 2½ month limit will generally result in an automatic violation of Section 409A. In contrast, where an arrangement provides in writing that a payment must be made by a specified date within the 2½ month limit, the failure to make payment by the specified date will not necessarily trigger a Section 409A violation, so long as the payment is ultimately made within the same calendar year as the specified date or qualifies for another exception provided under the Proposed Regulations. (Of course, if payments are delayed beyond the specified date, the sponsor of the deferred compensation plan may be exposed to claims by participants that they are owed interest on such amounts.)

The short-term deferral exception will <u>not</u> be available if a legally binding right to receive payment at a fixed date that is beyond the 2½ month limit is established at the outset of a given arrangement. In other words, once a fixed payment date (beyond the 2½ month limit) is established for an arrangement, the payment may not thereafter be accelerated to fall within 2½ months of the year in which the service provider's right to the compensation becomes vested, as that would be an impermissible acceleration of payment under Section 409A.

3. ***Requirement that a Plan be Written***. While the statute itself does not explicitly require a deferred compensation plan subject to Section 409A to be maintained as a written plan, the Proposed Regulations provide that plans covered by Section 409A will need to be in writing to satisfy the statutory requirements related to preestablishment of payment dates or events and to preclude any form of accelerated payouts not permitted under Section 409A. Additionally, as noted above, the Proposed Regulations suggest that arrangements that are intended to be exempt from Section 409A under the short-term deferral rule may also benefit from a written plan document, because maintaining a fixed payment date in writing may help the arrangement comply with Section 409A if the payment is ultimately delayed and therefore becomes subject to Section 409A.

4. ***Substantial Risk of Forfeiture***. For purposes of determining whether a service provider's right to compensation is vested, the Proposed Regulations generally adopt the same definition of "substantial risk of forfeiture" as provided under Notice 2005-1. Thus, while a forfeiture risk linked to a service provider's requirement to provide continuing substantial services will generally constitute a substantial risk of forfeiture for purposes of Section 409A, certain other forfeiture risks, such as one that is introduced with respect to a previously vested compensation arrangement, a forfeiture risk that is extended or "rolled" to a new time period, or a risk that is linked to a covenant not to compete, will not constitute a "substantial risk of forfeiture" for purposes of Section 409A.

C. PLAN AGGREGATION RULES.

The Proposed Regulations generally retain the plan aggregation rules set forth in Notice 2005-1 under which similar categories of plans maintained by a service recipient are aggregated on an individual participant basis for purposes of Section 409A, but establish a new category of plans covering separation pay arrangements. Thus, there are now four categories of deferred compensation plans for purposes of Section 409A:

- account balance plans (covering defined contribution plan arrangements);
- nonaccount balance plans (covering defined benefit plan arrangements);
- separation pay arrangements; and
- discounted stock options, SARs and other compensation arrangements not otherwise described above.

Under the plan aggregation rules, a participant's Section 409A violation with respect to a particular deferred compensation arrangement will generally cause the Section 409A failure to apply to all of the affected participant's deferred compensation arrangements with the same service recipient falling within the same category of plan (i.e., a failure with respect to one account balance plan will generally taint all of the participant's account balance plans for purposes of Section 409A). However, since the plan aggregation rules apply on an individual participant basis, a Section 409A violation with respect to one plan participant will not necessarily trigger a Section 409A failure for other plan participants.

D. INITIAL DEFERRAL ELECTION REQUIREMENTS.

The Proposed Regulations clarify that a deferral election is deemed to be made for purposes of Section 409A only once it has become irrevocable. Thus, evergreen deferral elections that remain in place from year to year unless the service provider changes the election will satisfy the deferral election timing requirements under Section 409A only if the election becomes irrevocable with respect to future compensation no later than the last permissible date an affirmative deferral election could have been made with respect to such compensation (generally, December 31 with respect to non-performance-based compensation scheduled to be earned in the following year).

For non-elective deferral arrangements (or arrangements that, absent an additional deferral, would be exempt from Section 409A under the 2½ month rule), the Proposed Regulations provide that the original designated time and form of payment will be treated as an initial deferral election, so that any subsequent changes to the payment date must comply with the re-deferral rules under Section 409A (i.e., the re-deferral election must be made at least 12 months prior to the previous distribution date, and must defer the compensation for at least 5 additional years). However, a service provider may make an initial deferral election (without regard to the 5-year re-deferral requirement) with respect to a non-elective deferred compensation award if the award will remain subject to a substantial risk of forfeiture for at least 12 months after the date of the election and the election is made within 30 days after the award is granted.

The Proposed Regulations also provide a potentially helpful relief provision under which a service provider who is receiving compensation based on a fiscal year other than a calendar year (e.g., a fiscal year bonus) may elect to defer the fiscal year compensation before the beginning of the applicable fiscal year (as opposed to the preceding December 31).

E. SPECIAL RULES FOR DEFERRAL OF PERFORMANCE-BASED COMPENSATION.

The performance-based compensation exception under Section 409A permits a deferral election to be made as late as 6 months prior to the end of the relevant performance period, rather than in accordance with the normal timing rules under Section 409A set forth above. In order to qualify as "performance-based compensation," (1) the performance period must be based on services performed over a period of at least 12 months, and (2) the payment of compensation must be contingent upon satisfaction of preestablished organizational or individual performance criteria that are not substantially certain to be met at the time the criteria are established. The Proposed Regulations require that these criteria be established in writing not later than 90 days after the start of the performance period.

While Notice 2005-1 provided that "performance-based compensation" would not include amounts payable based solely on the value of, or appreciation in value of, the service recipient or the stock of the service recipient, the Proposed Regulations eliminate this limitation, so that performance-based compensation <u>may</u> be based solely upon an increase in the value of the service recipient, or the stock of the service recipient, after the date of grant or award. However, the Proposed Regulations do clarify that if a compensation payment is not *solely* based on an increase in the service recipient's stock value (e.g., a stock option with an exercise price that is less than the grant date fair market value), and the payment would not otherwise qualify as performance-based compensation, then no portion of the compensation attributable to that grant or award will qualify as performance-based compensation.

F. TIME AND FORM OF PAYMENT.

As mandated by the statute, the Proposed Regulations set forth six general circumstances under which deferred compensation may be paid:

- the service provider's separation from service;
- the service provider's disability;
- the service provider's death;
- a time (or a fixed schedule) specified in the plan;
- a change in control of a corporation; and
- the occurrence of an unforeseeable emergency.

The Proposed Regulations clarify the application of these events as follows:

1. ***Scheduled Payment Dates***. Under the Proposed Regulations, the fixed time or fixed schedule requirement may be satisfied by specifying a specific date or by simply specifying the calendar year or years in which the payments are scheduled to be made. However, payments actually made prior to the later of (1) the end of the calendar year in which the specified date occurs or (2) 2½ months after the specified date, are deemed to satisfy the "specified date" criterion. Additionally, if calculation of the amount of the payment is not administratively practicable upon the original specified date due to events beyond the control of the service provider, the payment will be treated as made upon the date specified under the arrangement if payment is made during the first calendar year in which payment is administratively practicable. If a deferral arrangement specifies a calendar year (rather than a specific date) in which payment will be made, then the first scheduled payment date is deemed to be January 1 of that calendar year for purposes of the subsequent deferral election timing rules.

2. ***Specified Events***. Payments based upon the occurrence of permitted events – if not made on the occurrence of the event itself (which is normally impracticable) – must generally be specified to occur on an objectively determinable date or year following any such event. The Proposed Regulations provide some flexibility regarding when payment must be made following the occurrence of any of the five events, permitting payment by the later of (1) the first date it is administratively feasible to make such payment on or after the designated date or (2) at the end of the calendar year containing the designated date.

3. ***Delayed Payment***. A deferral arrangement may provide that payments will be delayed beyond their scheduled payment dates without violating Section 409A to the extent payments would otherwise not be deductible under Section 162(m) of the Code, violate securities laws or violate loan covenants, if such loan covenant violation would result in material harm to the service recipient. With respect to payments that are deferred due to deduction issues under Section 162(m), the payment cannot be deferred to a date later than the first calendar year in which the service recipient reasonably anticipates that a deduction for the payment will not be limited by Section 162(m) <u>or</u> the calendar year in which the service provider experiences a separation from service. Additionally, Section 409A will not be deemed to have been violated if a payment is not paid on the scheduled payment date due to the service recipient's failure or refusal to pay (provided the service provider acts in good faith to attempt to collect such unpaid amounts).

4. ***Separation From Service***. The Proposed Regulations include objective standards for determining when there has been a separation from service of a service provider, including treatment of leaves of absence and military leave. In addition, in the event of a "termination of employment" where the former service provider continues to provides services to the service recipient (e.g. a consulting arrangement), a separation will not be deemed to have occurred if continuing services and annual compensation exceed 50% of pre-"termination" levels and, conversely, a purported continuation of employment will be treated as a separation of service if services and annual compensation are reduced to less than 20% of their prior levels. These rules are intended to prevent taxpayers from circumventing the intent of Section 409A with sham separations from (or continuations in) service.

5. ***Special Rules for "Key Employees"***. The Proposed Regulations establish a testing period for determining which employee service providers of the service recipient are "key employees" for purposes of the requirement that payments to key employees of public companies that are triggered by a termination of employment be delayed for at least 6 months following such termination. Generally, the identification of "key employees" is made based on a 12-month period ending on an "identification date" established by the service recipient. Such individuals will be considered key employees for the 12-month period commencing on the 1st day of the 4th month following the end of such 12-month period. (For example, if the identification date is December 31 of each year, any key employees identified during the calendar year ending on December 31, 2008 would be treated as key employees for the 12-month period commencing April 1, 2009.) Deferral arrangements covering key employees should stipulate the manner in which payments that are mandatorily deferred during the 6-month period following separation from service will be handled (e.g., a lump sum payment in the 7th month following termination or an installment payment commencing in such 7th month).

6. ***Change in Control Payouts and "Earn-Out" Arrangements***. The statute limits payments triggered by a "change in control" to changes in control of corporations. Treasury has indicated its intent to provide additional guidance expanding the definition of "change in control event" to cover entities that are not taxable as corporations. Pending such guidance, the rules applicable to corporations may be applied by analogy to partnerships. Additionally, the Proposed Regulations clarify that participation by service providers in shareholder earn-out and similar delayed payment arrangements with respect to selling shareholders in connection with a change in control event will be deemed to satisfy the payment timing requirements of Section 409A, so long as the payments to service providers are made on the same basis and at the same times as payments to shareholders <u>and</u> <u>further</u> provided that all such payments are made within 5 years after the change in control event.

7. ***Multiple Payment Events***. Plans may provide that payments are made upon the earlier of, or the later of, two or more of the specified permissible payment events or times.

8. ***Permitted Acceleration Provisions***. The limited payment acceleration events set forth in Notice 2005-1 (e.g., payments to comply with domestic relations orders, payments necessary to comply with certain conflict of interest rules, payments to pay employment taxes and certain de minimis payments related to a participant's termination of participation in the plan) are retained in the Proposed Regulations. In addition, a plan may permit accelerated payments of up to the amount required to be included in a service provider's income as a result of the plan's failure to comply with Section 409A.

G. PLAN TERMINATIONS.

The Proposed Regulations permit the terms of a plan to provide for the termination of and corresponding acceleration of payments under a plan under the following 3 circumstances:

1. A service recipient may in its discretion terminate all nonqualified deferred compensation arrangements that must be aggregated under Section 409A (e.g. all account balance plans are terminated), provided that (i) payments not otherwise due under the plan are not paid out for at least 12 months, (ii) all payments are made within 24 months after termination and (iii) no similar type of plan is adopted by the service recipient for 5 years thereafter.

2. During the 30 days preceding or 12 months following a change in control event, the service recipient may elect to terminate a plan and make payment to all participants, provided that all substantially similar arrangements sponsored by the service recipient (presumably including plans maintained by the buyer following the corporate transaction) are terminated.

3. A plan may provide that it will be terminated within 12 months of a corporate dissolution taxed under Section 331 of the Internal Revenue Code or with the approval of a bankruptcy court, provided that the amounts deferred under the plan are included in the participant's gross income by the latest of (i) the calendar year in which the plan termination occurs, (ii) the calendar year in which the amount is no longer subject to a substantial risk of forfeiture or (iii) the first calendar year in which the payment is administratively practicable.

H. SUBSEQUENT CHANGES IN THE TIME AND FORM OF PAYMENT.

1. ***General***. Under Section 409A, subsequent deferral elections (i.e., extending the previously designated deferral period) are only permitted if:

(i) the plan requires that the election not take effect until at least 12 months after the date on which the election is made;

(ii) in the case of an election related to a payment other than on account of death, disability or unforeseeable emergency, the plan requires that the first payment with respect to which such election is made be deferred for a period of not less than 5 years from the date such payment would otherwise have been made; and

(iii) the plan requires that any election related to a payment at a specified time or pursuant to a fixed schedule may not be made less than 12 months prior to the date of the first scheduled payment.

2. ***Application to Installment Payments***. The Proposed Regulations provide some flexibility for parties to a deferred compensation plan to designate at the inception of the plan whether installment amounts payable under that arrangement are to be treated as a single payment, or as separate payments, for purposes of the timing requirements of subsequent elections. For example, if a 10-year installment payment is treated as a single payment and is scheduled to commence on July 1, 2010, then consistent with the 5-year subsequent deferral rule, a service provider generally could change the time and form of the payment to a lump sum payment on July 1, 2015. In contrast, if a 10-year installment payment is designated as 10 separate payments scheduled for years 2010 through 2019, then the service provider could not change the time and form of the payment to a lump sum payment to be made on July 1, 2015, because the separate payments scheduled for years 2011 through 2019 would not have been deferred for 5 additional years. The designation of installments as a single payment or a series of separate payments may be made by December 31, 2006 by plans that were previously silent on this issue. However, a life annuity must always be treated for these purposes as a single payment.

3. ***Alternate Forms of Payment***. Under the Proposed Regulations, a plan may provide for a different form of payment depending upon the payment event (e.g., a life annuity at age 65 or, if earlier, a lump sum upon separation from service). However, if multiple payment forms are provided, then the change in time and form of payment and anti-acceleration provisions will apply separately to each potential form of payment.

I. SPECIAL RULES RELATING TO STOCK OPTIONS AND SARS.

The Proposed Regulations answer many of the questions raised by the application of Section 409A to compensatory grants of options and SARs.

1. ***Stock Options***. Options to purchase "service recipient stock" granted at no less than fair market value of the underlying stock, and containing no other deferral feature, are exempt from the application of Section 409A, while options granted at a discount to such value or containing deferral features other than the deferral inherent in the option (or forfeiture restrictions on stock purchased pursuant to the option) are subject to Section 409A.

(a) *Service Recipient Stock*. Notice 2005-1 limited this favorable option treatment (i.e., the exemption from Section 409A for nondiscounted options) to options to purchase stock of the optionee's employer or a member of the same controlled group, based on an 80% common ownership test. Treasury loosened this 80% standard in the Proposed Regulations by substituting a 50% (or 20% in cases where there are "legitimate business criteria", such as a joint venture where the former employer holds a 20% interest in the joint venture) standard in lieu of the 80% standard. The designation of a 50% or 20% threshold must be applied on a consistent basis and a change in such percentage may not be made effective until 12 months after adoption of such change.

(b) *Separate Classes of Common Stock; Preferred Stock*. Due to concerns about manipulation, the Proposed Regulations provide that options are only exempt if they are granted with respect to common stock (or ADRs), as opposed to preferred stock. In addition, where a corporation has issued multiple classes of common stock, only the class of common stock that is publicly traded or, if none, the class having, on the date of grant, the greatest aggregate value of any class of common stock of the corporation outstanding or a class of common stock substantially similar to such class of stock (ignoring differences in voting rights) may qualify as "service recipient stock". There is a limited grandfather provision in the Proposed Regulations to the effect that any class of common stock with respect to which stock rights were granted on or before December 31, 2004, will constitute service recipient stock, but only for grants actually made on or before that date.

(c) *Valuation of Underlying Stock*. Recognizing the critical importance of determining whether an option was granted at a price at least equal to the fair market value of the underlying stock, the Proposed Regulations contain relatively detailed valuation provisions.

(1) <u>Public Companies</u>. In the case of public companies (i.e. those companies whose stock is readily traded on an established securities market), the value of stock may be determined by reference to:

- the last sale prior to, or the first sale after, the grant;
- the closing price on the trading day before the grant;
- the closing price on the trading day of the grant;
- any other reasonable basis using actual transactions and consistently applied; or

- an average of the price of the stock over a period of no more than 30 days before or after the grant date, but only if the terms of the grant are established before the beginning of the averaging period and the valuation method is used consistently for grants of stock rights under the same or similar programs.

(2) Private Companies. In the case of private companies, the fair market value of stock may be determined through the "reasonable application of a reasonable valuation method." Factors to be considered under a reasonable valuation method include, as applicable:

- the value of tangible and intangible assets;
- the present value of future cash flows;
- analysis of comparable companies' equity; and
- other relevant factors, such as control premiums or discounts for lack of marketability, and whether the valuation method is used for other purposes that have a material economic effect on the company, its stockholders or creditors.

In addition, a valuation method must take into consideration all available information material to the value of the company and a valuation is deemed stale if made more than 12 months prior to the grant for which it is being applied. The following methods of valuation, while not exclusive, are presumed to be reasonable, if used consistently while the issuer remains private (assuming the method is also used for grants, puts and calls, where applicable):

- an independent appraisal that meets the requirements of Section 401(a)(28)(C) of the Code (relating to ESOPs) made within the last 12 months preceding the grant date;
- a valuation based on a nonlapse restriction (as defined under Section 83 of the Code) that is also used for all other noncompensatory purposes, including regulatory filings, loan covenants, sales and repurchases of shares to and from shareholders and for other third-party arrangements (and provided further that the stock must be nontransferable by the service provider except through the operation of the nonlapse restriction); and
- a good faith valuation of illiquid stock of a start-up corporation, evidenced by a written report by a person with significant knowledge

and experience or training in performing similar valuations, that takes into account the general factors set forth above with respect to private company valuations, generally.

Under the "illiquid stock" valuation test, (i) the corporation and its predecessors cannot have been conducting their business for 10 years or more, (ii) the stock cannot be subject to any put or call obligation (other than a right of first refusal or a put or call that lapses with time) and (iii) it cannot be reasonably anticipated that the corporation will undergo a change in control or IPO within 12 months following the grant or other event to which the valuation was applied.

Valuation methods may be changed for purposes of new grants.

(d) *Effect of Option Modifications*. Importantly, the Proposed Regulations explicitly deal with circumstances under which outstanding options will be treated as having been regranted due to a modification in the terms of the option. There are two types of modification described in the Proposed Regulations. The first is a direct or indirect reduction in exercise price and is a deemed regrant. The second is an extension or renewal of the option, which is further described below. On the date of the deemed regrant, if the options are "in the money", the resulting "regranted" option will fail to meet the requirements that the option price must equal or exceed the fair market value of the stock on the date of grant and the options will become subject to the rules of Section 409A.

Actions that <u>would</u> constitute regrants include:

- lowering the exercise price of an option; and
- changing the terms of the stock subject to a stock option in a manner that increases the value of such stock (e.g., a change in a put or call right, or the elimination of a non-lapse restriction).

Actions that would <u>not</u> result in a regrant include:

- acceleration of exercisability of an option;
- making an option transferable, if that right has been specifically reserved by the grant;
- according to the preamble to the Proposed Regulations, providing the optionee with the ability to cash out of the option at the spread between fair market value and option exercise price (this exclusion would seem

to permit optional cashouts of stock options in merger and acquisition transactions without running afoul of Section 409A);

- amending an option to permit exercise of the option with pre-owned stock; and

- amending an option to permit a netting of required tax withholding from stock to be delivered pursuant to the option.

By contrast, a modification extending or renewing an option will be treated as the addition of a deferral feature to the original grant, and will accordingly result in subjecting the option to Section 409A taxation, except for:

- extensions of the original exercise period to the later of 2½ months after, or the end of the calendar year in which, the option otherwise would have expired; and

- extensions of the original exercise period to prevent violations of applicable securities laws, if the extension is not longer than 30 days beyond the first date that exercise of the option would no longer have involved a violation of the applicable securities laws.

(e) *Permitted Substitutions or Rollovers in Corporate Transactions*. The Proposed Regulations provide that certain substitutions and rollovers in corporate transactions are not modifications that result in the regrant of a stock right if the substitution or rollover conforms to the rules applicable to ISOs (other than with respect to exercise price adjustment, as described below).

- The first effect of applying the ISO rules is presumably to incorporate the definition of "corporate transaction" from the ISO rules. The applicable ISO regulations define a "corporate transaction" to include a merger, consolidation, acquisition of property or stock, separation, reorganization or liquidation, a distribution other than an ordinary dividend, a change in the terms or number of outstanding shares of a corporation, or such other corporate events as may be prescribed by the Secretary of Treasury.

- The second effect of applying the ISO rules is to provide that in order for a substitution or rollover to avoid invoking a regrant analysis, the new or assumed option must contain all terms of the old option (except to the extent the corporate transaction rendered them inoperative), and the new or assumed option must not give the holder any additional benefits.

- The Proposed Regulations relax the third aspect under the ISO rules, relating to the adjustment of the number of shares covered by the option and the exercise price requirements, by providing the following means of avoiding a regrant in connection with the option rollover:

(1) the aggregate spread between the option exercise price and fair market value of the underlying stock must not be greater immediately after the rollover than immediately prior to the rollover; <u>and</u>

(2) the ratio of the exercise price to the fair market value of the underlying stock immediately after the rollover must be the same *or lower than* such ratio immediately prior to the rollover.

If the corporate transaction is a spinoff by a publicly held company, in computing the foregoing tests the value of stock may be determined over a period of not more than 30 days ending not more than 60 days after the spinoff transaction.

2. ***Stock Appreciation Rights***. Under the Proposed Regulations, stock appreciation rights, whether payable in stock or cash, and whether the issuer is a public or private company, are treated the same, for purposes of the foregoing and following discussions, as options.

3. ***Other Option Issues***.

- If an option is amended to provide that the grantor, at its discretion, may afford the holder an additional benefit, and the additional benefit, if afforded, would be a modification, the addition of the discretion is itself a modification that would constitute a regrant or impermissible extension for purposes of Section 409A.

- An inadvertent modification to an option may be rescinded by the earlier of the date the option is exercised or the last day of the calendar year in which such inadvertent modification occurred.

- If the optionee has a right upon exercise of the option to receive all or part of the dividends paid on the underlying shares, the receipt of the dividends will be deemed a reduction in exercise price which generally will make the option subject to Section 409A, <u>unless</u> the right to receive such dividends is explicitly set forth as a separate arrangement that itself complies with Section 409A.

- The application of the Section 409A stock option rules to non-corporate entities is generally not addressed in the Proposed Regulations, and the Treasury is seeking further comment on this issue. However, as noted below in M. "Arrangements between Partners and Partnerships," until such further guidance is issued, taxpayers may rely on Notice 2005-1 which generally provides that options on partnerships may be treated, by analogy, in the same manner as options on shares of a corporation.

J. NONQUALIFIED DEFERRED COMPENSATION PLANS LINKED TO TAX-QUALIFIED PLANS.

The Proposed Regulations clarify the application of Section 409A where, under the terms of a nonqualified deferred compensation plan, the amount deferred under such plan is based on the formula used to determine benefits under a tax-qualified plan. The Proposed Regulations afford the following relief from Section 409A to the coordinated operation of these plans:

1. Neither a decrease or increase in the benefits under a nonqualified plan that results from an amendment to a qualified plan will be considered an impermissible change to a deferral or payout election under Section 409A.

2. A service provider's action or inaction with respect to an elective deferral under a qualified plan that increases the amount of his or her nonqualified deferred compensation will not be considered a violation of Section 409A, so long as for any given calendar year, the increase does not exceed the legal limitation on elective deferrals under the qualified plan for such year.

K. SEPARATION PAY ARRANGEMENTS.

The Proposed Regulations explicitly reject the notion of exempting severance pay arrangements from coverage under Section 409A. However, under the Proposed Regulations, amounts paid pursuant to involuntary separations of service severance arrangements or under a "window program" are excluded from potential taxation under Section 409A if the entire amount does not exceed two times the terminated employee's compensation for the year prior to termination (or, if less, two times the annual limit on amounts taken into account as compensation under qualified plans, currently $210,000), and the amounts are paid by December 31 of the second calendar year after the calendar year in which the termination occurred. To the extent, however, that separation pay acts as a substitute or replacement for amounts otherwise deferred (e.g., payment in consideration for foregoing rights to receive payments otherwise owed under a deferred compensation plan), it will not qualify for relief as a separation pay arrangement.

Treasury also rejected the notion that individual severance arrangements should be excluded from coverage under Section 409A, but acknowledged that such arrangements may be structured to qualify for the short-term deferral exemption from Section 409A (generally related to bonuses and other short term deferral arrangements) by providing that the entire severance amount must be paid within 2½ months after the year in which the involuntary termination occurred.

Expressing concern over the use of "good reason" terminations (in essence a voluntary termination by the service provider after some type of constructive termination by the service recipient) as a way of permitting abuse, Treasury was not willing to provide the relief described in the preceding two paragraphs for such terminations (although the severance payments may still be structured to comply with the general requirements under Section 409A with respect to payments made in connection with a separation from service), so that for example, in public companies, severance payments made upon good reason terminations of key employees will remain subject to the "key employee" six-month deferral rule. Instead, they are soliciting comments on what further guidance is needed.

The Proposed Regulations also provide relief to the extent severance arrangements provide reimbursement for reasonable outplacement expenses, reasonable moving expenses, medical expenses and certain other deductible business expenses for a limited period of time (which may not extend beyond December 31 of the second calendar year following the calendar year in which the separation from service occurred).

L. ACCRUAL METHOD TAXPAYERS; ARRANGEMENTS WITH INDEPENDENT CONTRACTORS, INCLUDING DIRECTORS.

As was the case in Notice 2005-1, Section 409A does not apply to amounts deferred in a taxable year by a service provider who uses accrual method accounting for tax purposes. It also does not apply to an arrangement between an unrelated independent contractor (other than a director of a corporation) and a service recipient if, during that taxable year, the independent contractor provides significant services to two or more service recipients who are independent of each other and the independent contractor. There is a safe harbor rule providing that if no more than 70% of the independent contractor's revenues come from any one service recipient, the independent contractor will be deemed to be providing significant services to two or more service recipients.

However, this exclusion from Section 409A does not apply to a director of multiple unrelated corporations, and the director will be subject to Section 409A with respect to each deferred compensation arrangement for the various corporations that he or she serves as director. However, to the extent any such arrangement results in the director's recognition of income with respect to that program due to a Section 409A violation, that violation will not necessarily taint other unrelated directors' arrangements.

With respect to a director who also serves as a full-time employee of the service recipient, the director arrangement will not be aggregated with the employee arrangements for purposes of the aggregation of arrangements rules under Section 409A, so long as other non-employee directors' compensation is determined under the same or substantially similar arrangements.

M. ARRANGEMENTS BETWEEN PARTNERS AND PARTNERSHIPS.

The Proposed Regulations allow taxpayers to continue relying on Notice 2005-1, Q&A-7, the interim guidance related to Section 409A's application to arrangements between partners and their partnerships. They also provide that until further guidance is issued, Section 409A <u>will</u> apply to guaranteed payments (as described in Section 707(e) of the Code), <u>only</u> <u>where</u> the guaranteed payment is for services and the partner does not include the payment until the 15th day of the third month following the end of the fiscal year where the partners obtained a legally binding right to the guaranteed payment or, if later, the year when the guaranteed payment was no longer subject to a substantial risk of forfeiture.

N. CLARIFICATION OF GRANDFATHERED PLAN STATUS.

Generally, Section 409A applies to amounts deferred under nonqualified deferred compensation plans that were not earned or vested by a service provider as of December 31, 2004. For purposes of determining whether Section 409A is applicable with respect to a deferred amount (and therefore whether a deferred amount is considered "grandfathered" and not subject to Section 409A), an amount is considered deferred if, as of December 31, 2004, (1) the service provider had a legally binding right to be paid the amount and (2) the right to the amount was earned and vested. The Proposed Regulations have attempted to clarify how this rule is to be applied to various forms of deferred compensation, as described below.

1. ***Equity-Based Compensation***. Stock options, stock appreciation rights, and other similar compensation that, on or before December 31, 2004, were immediately exercisable for cash or substantially vested property (meaning property not subject to a substantial risk of forfeiture under Section 83 of the Code), will not be considered deferred compensation subject to Section 409A.

2. ***Grandfathered Amounts—Account Balance Plans.*** The portion of the service provider's account balance, as of December 31, 2004, that is earned and vested, also as of December 31, 2004, plus any earnings thereon after December 31, 2004, will be grandfathered.

3. ***Grandfathered Amounts—Nonaccount Balance Plans.*** The present value, as of December 31, 2004, of the maximum amount available to the service provider if he or she had voluntarily resigned on such date, is grandfathered. The grandfathered amount would also include the present value of additional amounts the participant may actually receive, pursuant to the terms of the plan as in effect on October 3, 2004, without regard to any further services rendered by such participant after December 31, 2004 (e.g., increased benefits upon the achievement of a specified age).

4. ***Material Modifications; Relief for Inadvertent Material Modification***. Section 409A provides that if an otherwise grandfathered plan is materially modified, all amounts previously grandfathered under such plan will become subject to Section 409A. The Proposed Regulations provide guidelines for those actions that will and will not be considered material modifications, as well as a limited opportunity to rescind such actions.

(a) *Definition of Material Modification*. Generally, a material modification to an otherwise grandfathered plan occurs when (1) a benefit or right existing as of October 3, 2004 is materially enhanced, or a new material benefit or right is added, and (2) such material enhancement or addition affects amounts earned and vested before January 1, 2005, regardless of whether occurring pursuant to a plan amendment or a service provider's exercise of discretion under the terms of the plan.

(b) *Exceptions to Definition of Material Modification*. The following actions will not constitute material modifications to otherwise grandfathered plans:

- amending a plan to bring it into compliance with Section 409A;
- reduction of an existing benefit;
- exercise of a right by a service provider under the plan as in effect on October 3, 2004;
- exercise of discretion by service recipient over the time and manner of payment of a benefit, to the extent such discretion is provided under the terms of the plan as of October 3, 2004;
- cessation of deferrals or termination of a plan, pursuant to its terms; and
- changes to or additions of investment measures used in account balance plans, so long as such investment measure qualifies as a predetermined actual investment under certain other regulations, or otherwise reflects a reasonable rate of interest (as determined under such other regulations).

(c) *Rescission of Inadvertent Material Modifications*. A material modification, if made, will not cause an otherwise grandfathered plan to become subject to Section 409A if the material modification is rescinded before the earlier of (i) the date the additional right under the modification is exercised (if the change grants a discretionary right) and (ii) the end of the calendar year in which the modification is made.

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