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## IRS Issues Final Regulations under Section 409A

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### Overview

On April 10, 2007, the IRS issued long-awaited final regulations on nonqualified deferred compensation under Section 409A of the Internal Revenue Code (the Code). This alert highlights some of the changes made from the proposed regulations--a more detailed analysis will follow. The final regulations are scheduled to become effective on January 1, 2008, by which date all nonqualified deferred compensation arrangements must be in documentary compliance with the final regulations. Until then, nonqualified deferred compensation arrangements must be operated in good faith compliance with the final regulations, the proposed regulations or other guidance issued under Section 409A.

### Background

The American Jobs Creation Act of 2004 added Section 409A to the Code, which provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in income, unless strict timing and documentary requirements are satisfied. A violation of Section 409A results in the assessment of a 20% tax and interest on the employee or service provider, in addition to regular income and employment taxes. Proposed regulations were issued on October 4, 2005. The Treasury Department and the IRS have issued six additional notices providing transition guidance with respect to Section 409A.

### The Final Regulations

Overall, the final regulations do not fundamentally alter the approach taken by the proposed regulations; rather, they include numerous clarifications and minute changes, and provide more examples to assist practitioners and taxpayers. The following is a list of highlights from the final regulations:

- Severance payments made upon terminations for good reason may, in certain cases, be treated as payments made upon involuntary termination and be exempt from Section 409A.
- An option's or stock appreciation right's exercise period may be extended to its original

maximum term (determined as if the employee remained employed) or 10 years from the original date of grant, whichever is shorter, without triggering Section 409A; additional relief is granted for the extension of underwater stock rights.

- Flexibility is added to the valuation methodologies for privately held stock as the consistency requirement is dropped and the requirements for the start-up corporation safe harbor are loosened.
- The rules applicable to reimbursement arrangements, specified employee determinations, separation from service, plan aggregation, separation pay, payment events and grandfathered amounts (among others) are liberalized.
- The definition of service recipient stock is expanded both as to the classes of stock covered and the issuing entities, allowing stock grants to be made over shares of certain subsidiaries or other entities to be exempt from Section 409A.
- Specification of the time and form of payment under a nonelective plan is not required until such time as an election would be required if the plan were elective.
- The rules with respect to deferral elections, permissible accelerations, subsequent elections and linked plan elections are clarified.

#### Important Omissions

The final regulations do not contain guidance on the application of Section 409A to arrangements between partnerships and partners. In addition, the final regulations do not address the calculation of amounts required to be included in income upon a violation of Section 409A, or the timing of the inclusion (good faith compliance with existing guidance should continue). As expected, no model amendment is anticipated.

#### Our Recommendations

All nonqualified deferred compensation arrangements should be reviewed and revised for compliance with the final regulations. Even nonqualified deferred compensation arrangements that were drafted (or amended) to comply with the proposed regulations should be carefully reviewed to determine if any further changes are required to comply with the final regulations. The deadline for making such revisions is December 31, 2007.

For more information on this or other tax matters, please see our prior [tax publications](#), or contact:

##### **A. William Caporizzo**

+1 617 526 6411

[william.caporizzo@wilmerhale.com](mailto:william.caporizzo@wilmerhale.com)

##### **R. Scott Kilgore**

+1 703 251 9744

[scott.kilgore@wilmerhale.com](mailto:scott.kilgore@wilmerhale.com)

##### **Amy A. Null**

+1 617 526 6541

**amy.null@wilmerhale.com**

**William H. Schmidt**

**+1 617 526 6946**

**bill.schmidt@wilmerhale.com**

**Linda K. Sherman**

**+1 617 562 6712**

**linda.sherman@wilmerhale.com**

**Kimberly B. Wethly**

**+1 617 526 6481**

**kimberly.wethly@wilmerhale.com**