

CLIENT ALERT

OCTOBER 7, 2005

IRS PROPOSES NEW SECTION 409A REGULATIONS

On September 29, 2005, the U.S. Treasury and Internal Revenue Service issued proposed regulations under Internal Revenue Code Section 409A (Section 409A).

Background

Section 409A was enacted in October 2004 as part of the American Jobs Creation Act. In December 2004, the Internal Revenue Service (IRS) issued Notice 2005-1, which provided some transition guidance for complying with Section 409A. Under Section 409A, unless certain requirements are satisfied, amounts deferred under a nonqualified deferred compensation plan are currently includable in gross income unless the amounts are subject to a substantial risk of forfeiture or previously were included in gross income. Such deferred amounts are also subject to an extra 20 percent income tax.

Highlights of the Proposed Regulations

The proposed regulations are comprehensive and cover 238 pages. This memorandum explains the proposed regulations in detail and provides a complete index of questions based on topics at the end of this memorandum. Highlights include:

- Amending previously granted stock options and other equity awards, including extending post-termination exercise periods, may present issues under Section 409A (pages 9-11).
- Certain severance plans, including individual employment and severance agreements, also may present issues under Section 409A (pages 13-15).
- Strict private company stock valuation guidelines have been provided (pages 7-9).
- Certain stock appreciation rights (SARs) settled in cash or stock may now be issued by public and private companies (pages 5-6).
- Elections to defer compensation are subject to strict requirements (pages 11-13).
- The proposed regulations may be relied upon immediately and certain plans will need to be amended by December 31, 2006 (pages 2-4).

What are the key action items to comply with Section 409A?

The scope of Section 409A's coverage extends from traditional executive deferred compensation plans to certain severance pay to equity compensation. We recommend that the following steps be taken:

- Identify all plans, agreements, and arrangements that *may* provide for deferred compensation under Section 409A. (For purposes of this memorandum, the term "plan" includes traditional plan documents and other individual agreements and arrangements that may be subject to Section 409A.) (page 4)
- Confirm that stock option and SAR exercise prices are determined in accordance with Section 409A valuation guidelines. (pages 7-9)
- Confirm that the process in place for making deferral elections under traditional deferred compensation plans complies with Section 409A. (pages 11-13)
- Review and revise severance and change-in-control plans to comply with Section 409A. (pages 13-15)

A complete index is available on pages 27-31.

Effective Dates and Deadlines

What is the effective date of Section 409A and the proposed regulations?

Section 409A covers amounts deferred (and earnings on such amounts) in taxable years beginning on or after January 1, 2005. It also applies to amounts deferred (and earnings on such amounts) in taxable years prior to 2005 if the plan under which the deferral was made was or is materially modified after October 3, 2004. (See below for a description of what constitutes a material modification.)

The IRS intends the Section 409A proposed regulations to become effective for tax years beginning on or after January 1, 2007. Until the final regulations are adopted, taxpayers may rely on the proposed regulations. The IRS expects that Notice 2005-1 will superseded by the adoption of the final rules, but until then Notice 2005-1 remains applicable.

Although employers generally were required to immediately comply with the rules on a going-forward basis, Notice 2005-1 generally gave employers until the end of 2005 to bring their plan documents into compliance with Section 409A. The proposed regulations generally extend this relief until the end of 2006.

When is the deadline for amending plans to comply with Section 409A?

Each plan must be amended to comply with Section 409A or to remove the plan from Section 409A's scope by December 31, 2006. This extends Notice 2005-1's deadline of December 31, 2005.

Has the good faith compliance period been extended?

Yes. The proposed regulations extend Notice 2005-1's good faith compliance period through December 31, 2006. Throughout that time, the plan must be operated in good faith compliance with the requirements of Section 409A. After the good faith compliance period, such plans will need to be operated in strict compliance with Section 409A and its final regulations. Good faith compliance means that the plan is operated under a reasonable interpretation of the proposed regulations and Notice 2005-1.

When is the deadline for a participant to change payment elections?

A plan may be amended and a participant may generally change his or her election for the form and timing of distributions until December 31, 2006. During this time, such a change will not violate the Section 409A rules against acceleration and will not be considered an impermissible subsequent deferral under Section 409A. This extends Notice 2005-1's original deadline of December 31, 2005.

However, a participant cannot make a payment election change in 2006 relating to payments he or she otherwise would receive in 2006. A participant also cannot make a payment election change in 2006 that would cause a payment to be made in 2006 if it otherwise would not have been.

May deferral elections be cancelled or plan participation terminated throughout the extended good faith compliance period?

No. The proposed regulations do not extend the period of time during which participants may cancel their deferral elections or cancel their plan participation. As a result, participants have only through the end of 2005 to terminate plan participation or cancel deferral elections made in 2005, as was originally provided by Notice 2005-1. Plan participation decisions and deferral elections made with respect to 2006 compensation may not be canceled after December 31, 2005.

May initial deferral elections be made throughout the extended good faith compliance period?

No. The proposed regulations do not extend the period of time during which participants may make initial deferral elections (described below) with respect to compensation for services provided on or before December 31, 2005. Notice 2005-1 allowed deferrals to be made on or before March 15, 2005, for compensation to be earned in calendar year 2005. As a result of the IRS decision not to extend this time period, elections to defer calendar year 2006 compensation generally must be made by December 31, 2005.

May stock options and SARs that do not comply with Section 409A be fixed?

Yes. The proposed regulations permit replacing a stock option or SAR that otherwise would be subject to Section 409A (for example, a discount stock option or SAR) with a stock option or SAR that is not subject to Section 409A (for instance, non-discount stock options or SARs). However, the cancellation and replacement of the stock option or SAR must occur by December 31, 2006 (or December 31, 2005, if the optionee will be compensated for the lost discount).

Deferred Compensation in General

What is a nonqualified deferred compensation plan?

Under the proposed regulations, a nonqualified deferred compensation plan is any plan that provides for deferred compensation. This may include single arrangements between individual participants and employers, including certain employment and change-in-control agreements. The definition does not include qualified retirement plans, tax-deferred annuities, simplified employee pensions, and certain welfare benefit plans, such as vacation leave, sick leave, compensatory time, disability pay, and death benefit plans.

The definition of nonqualified deferred compensation plan also excludes certain foreign plans under which participation by an individual is addressed by a treaty between the relevant foreign jurisdiction and the U.S.

What is deferred compensation under Section 409A?

A plan provides deferred compensation if, under the terms of the plan and the relevant facts and circumstances:

- a participant has a legally binding right during a taxable year to compensation that has not been constructively or actually received;
- such compensation is not included in the participant's gross income; and
- such compensation is payable in a later year under the plan.

Example: In Year 1, a participant is promised a bonus equal to a percentage of the employer's annual profits to be paid in Year 3, provided the participant is still employed through the payment date. Therefore, for purposes of Section 409A, the participant is considered to have a legally binding right to receive this bonus subject to the condition of remaining employed through the payment date. This plan is covered by Section 409A. Because the payment is made upon vesting, the plan should comply with Section 409A and not be subject to the additional 20 percent tax due to the short-term deferral exemption discussed in the next section.

Under the proposed regulations, there is no legally binding right to receive compensation if an employer can unilaterally reduce the amount of the compensation or completely eliminate such compensation. The right to receive the compensation, however, will be legally binding if the facts

and circumstances indicate that the discretion to reduce or eliminate the compensation is conditional, or if the discretion to reduce or eliminate lacks substantive significance. In such case, the participant will have a legally binding right to receive the compensation. The participant also will have a legal right to the compensation if the participant has control over the person who has discretion over payment of the compensation.

Short-Term Deferrals

Are short-term deferrals considered deferred compensation under Section 409A?

Short-term deferrals will not be considered deferred compensation under Section 409A if, absent an election to defer the payment until a later date, the terms of the plan at all times require payment by (and the payment is actually received by the participant) the later of: (a) the date that is two-and-a-half months from the end of the participant's first taxable year in which the payment is no longer subject to a substantial risk of forfeiture, or (b) the date that is two-and-a-half months from the end of the employer's year in which the payment is not subject to a substantial risk of forfeiture.

Any plan that complies with the two-and-a-half-month rule may be unwritten if the payment is made by the appropriate deadline. If the plan is written, the proposed regulations provide some flexibility for payments delayed due to unforeseen administrative or solvency issues described below. This distinction between written plans and unwritten plans is intended to encourage employers to put their plans in writing.

What if the short-term deferral is delayed due to an unforeseeable event?

A payment that qualifies as a short-term deferral but is paid after the two-and-a-half-month deadline may continue to qualify as a short-term deferral if the plan is in writing and the taxpayer establishes that it was administratively impracticable to make the payment by the applicable deadline, or that making the payment on time would have jeopardized the employer's solvency. This exception only applies if, as of the date upon which the right to the compensation arose, such impracticability or insolvency was unforeseeable. The payment then must be made as soon as reasonably practicable following the date it would no longer be administratively impracticable or jeopardize the employer's solvency.

Stock Options and Other Equity Compensation

Are stock options and SARs considered deferred compensation under Section 409A?

Stock options generally will be exempt from Section 409A if:

- the exercise price of the option is no less than the fair market value of the underlying stock as of the grant date and the number of shares subject to the option is fixed on the grant date; and
- the option does not provide for the deferral of compensation past the exercise date.

SARs generally will be exempt from Section 409A if:

- the amount payable under the SAR is not greater than the difference between the fair market value of the stock on the SAR grant date and the fair market value of the stock on the SAR exercise date, with respect to a number of shares fixed on or before the grant date;
- the exercise price of the SAR is no less than the fair market value of the underlying stock on the grant date; and
- the SAR does not provide for deferral of compensation past the exercise date.

The grant of a statutory option (an incentive stock option or option granted under an employee stock purchase plan) will not be considered deferred compensation. However, modifying a statutory option may cause it to become subject to Section 409A, as discussed below.

What is a “stock right” for purposes of Section 409A?

A “stock right” means a stock option (other than a statutory option) or a SAR.

Which participants may be granted stock rights?

The initial guidance from Notice 2005-1 excluded stock options from Section 409A only if such options were granted to: (a) employees of the issuing company, and (b) such company’s 80 percent owned subsidiaries. The proposed regulations, however, extend the exclusion from Section 409A to stock options granted to employees of the issuing company’s 50 percent owned subsidiaries and, where a legitimate business reason exists (for example, for awards to employees of a joint venture), to 20 percent owned subsidiaries.

What stock can be subject to stock rights?

Stock options and SARs will be excluded from Section 409A only if the stock subject to such stock right is the issuer’s common stock having the highest aggregate value of any class of common stock (or is of a class of common stock substantially similar to that class, other than with respect to voting rights). Consequently, stock options for preferred stock or any other class of stock that provides a preference as to dividends or liquidation rights will be subject to Section 409A. Notwithstanding this new requirement, the proposed regulations provide that a stock right granted on or before December 31, 2004, will not be covered by Section 409A simply because the award is subject to a different class of common stock. Because of this rule, granting new options for preferred stock likely will be untenable.

The proposed regulations also clarify that, in most cases, American Depositary Receipts (ADRs) and certain equity appreciation rights issued by mutual companies will be considered stock pursuant to which options and SARs may be granted and will still be excluded from Section 409A.

Valuation of Stock Subject to Stock Rights

Do the regulations provide guidance on the valuation of stock subject to stock rights?

Yes. The proposed regulations provide guidance regarding acceptable methods for determining the fair market value of: (a) readily tradable (public company) stock, and (b) stock not readily tradable (private company stock).

These regulations represent a significant change in the process for determining the fair market value of private company stock. In order to comply with Section 409A and thus avoid early optionee income recognition and, potentially, a 20 percent additional tax, prior to option exercise, most private companies will need to significantly revamp their fair market value determination process.

What are the acceptable methods for determining fair market value of public company stock?

The fair market value of public company stock may be based upon:

- the last sale before or the first sale after the grant;
- the closing price on the trading day before or the trading day of the grant;
- any other reasonable basis using actual transactions in such stock as reported by such market and consistently applied; or
- the average selling price during a specified period that is within 30 days before or 30 days after the grant if the valuation is consistently applied for similar stock grants.

What are the acceptable methods for determining fair market value of private company stock?

The fair market value of private company stock must be determined, based on the private company's own facts and circumstances, by the application of a reasonable valuation method. A method will *not* be considered reasonable if it does not take into consideration all available information material to the valuation of the private company.

The 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;
- the readily determinable market value of similar entities engaged in a substantially similar business; and
- other relevant factors such as control premiums or discounts for lack of marketability.

How often do private companies need to perform fair market valuations?

The continued use of a previously calculated fair market value is not reasonable if:

- the initial valuation fails to reflect information available after the initial date of the valuation that materially affects the value of a private company (for example, resolving material litigation or receiving a material patent); or
- the value was calculated as of a date that is more than 12 months earlier than the date for which the valuation is being used.

Is there a presumption of reasonableness?

Yes. The proposed regulations provide a presumption that the fair market value determination will be considered reasonable in certain circumstances, including: (a) if the valuation is determined by an independent appraisal as of a date no more than 12 months before the transaction date, or (b) if the valuation is of “illiquid stock of a start-up corporation” and is made reasonably, in good faith, evidenced by a written report, and takes into account the relevant valuation factors described above.

This presumption of reasonableness is rebuttable only upon a showing by the IRS that either the valuation method, or the application of such method, was “grossly unreasonable.”

What is an “illiquid start-up corporation”?

Stock will be considered to be issued by an “illiquid start-up corporation” if:

- the company has not conducted (directly or indirectly through a predecessor) a trade or business for a period of 10 years or more;
- the company has no class of securities that are traded on an established securities market;
- the stock is not subject to put or call rights or other obligations to purchase such stock (other than a right of first refusal or other “lapse restriction” such as the right to purchase unvested stock at its original cost);
- the company is not reasonably expected to undergo a change in control or public offering within 12 months of the date the valuation is used; and
- the valuation is performed by a person or persons “with significant knowledge and experience or training in performing similar valuations.”

This may result in additional expense and burden for smaller companies (for example, having to hire an appraisal firm). Also, this could be problematic for companies issuing stock options or SARs within a year prior to a change in control or an initial public offering.

Are the typical, historical fair market value determinations made by private company boards of directors permissible under Section 409A?

Generally, no. The proposed regulations likely will significantly change the method by which a private company determines the fair market value of its stock. For example, valuation of private company stock solely by reference to a ratio related to the value of preferred stock generally will not be reasonable. Specifically, to comply with the proposed regulations, the valuation of “illiquid start-up corporation stock” must be:

- evidenced by a written report which takes into account the relevant valuation factors discussed above; and
- performed by a person or persons with significant knowledge and experience or training in performing such valuations.

Consequently, unless a private company board includes a director, or directors, who would satisfy the “significant knowledge and experience” requirement or a company employee satisfies this requirement, the determination of fair market value most likely will need to be made by an independent appraisal. However, if one of the private company directors is a representative of a venture capital investor, or if the company employs individuals with financial expertise who would satisfy the “significant knowledge and experience” requirements, it may be permissible for the written valuation report to be prepared by such individuals.

Modifications, Substitution, and Assumption of Stock Rights

How are modifications to stock rights treated?

Any modification of the terms of a stock right, other than an extension or renewal of the stock right, is considered to be the granting of a new stock right. The new stock right (as modified) should be analyzed to determine whether or not it constitutes deferred compensation subject to Section 409A.

When is a stock right considered modified?

A stock right will be considered modified, *whether or not the stock right holder in fact benefits from the changed terms*, if any such change in the terms of the stock right (including changes to any plan under which the stock right was granted) results in:

- a direct or indirect reduction in the exercise price;
- the inclusion of an additional deferral feature; or
- the extension or renewal of the stock right (for example, generally, adopting a change-in-control plan that extends the post-termination exercise period of outstanding options).

What are not considered modifications?

The proposed regulations provide that the following changes are not considered modifications of a stock right:

- shortening the period during which the stock right is exercisable;
- adding the ability to use previously acquired stock to pay the exercise price;
- adding the ability to withhold stock to satisfy tax withholding requirements;
- the company exercising discretion specifically permitted under the stock right with respect to the transferability of the stock right; and
- accelerating the vesting and exercisability of a stock right not previously subject to Section 409A.

Is an amendment that extends the exercise period of an option or SAR a modification?

Yes. Unless the amendment meets the requirements listed below, the amendment is considered a modification of the stock right (and the addition of an additional deferral feature) that results in the stock right being subject to Section 409A *from the original grant date*.

However, the proposed regulations do provide a safe harbor in that a stock right will not be considered to have been modified if the exercise period is extended to a date no later than the later of: (a) the 15th day of the third month following the date on which the stock right otherwise would have expired, or (b) December 31 of the year in which the stock right otherwise would have expired.

For example, a stock option granted on January 1, 2006, that expires upon the earlier of January 1, 2016, or 30 days after the employee's termination of employment will not be considered modified if, upon the employee's termination on July 1, 2010, the post-termination exercise period is extended to December 31, 2010.

Note that it is important to consider these rules when negotiating severance plans that may extend post-termination exercise periods because such arrangements could inadvertently cause an issue under Section 409A. Also, such modifications could result in unfavorable accounting consequences.

Moreover, permitting an employee to take a leave of absence as a prelude to employment termination or allowing the employee to continue providing nominal services following full-time employment could be treated as a modification if that extends the exercisability of an option or SAR beyond the permissible limits.

Is the substitution or assumption of stock rights in corporate transactions treated as a modification or the granting of a new stock right under Section 409A?

Generally, no. If the rules of Code Section 424 (relating to the substitution and assumption of statutory options) would be met if the stock right were a statutory option and if the ratio of the exercise price to the fair market value of the stock immediately after the substitution or assumption is not greater than the ratio of the exercise price to the fair market value of the stock immediately before the substitution or assumption, the stock right will not be considered to be modified as to the form of payment or be considered a new grant.

Can a company cure an inadvertent modification to a stock right?

Yes. Any change to a stock right that inadvertently would result in treatment as a modification as described above is not considered a modification if the company fixes the inadvertent modification by the earlier of the date that the stock right is exercised or by December 31 of the calendar year during which such change occurred.

Certain Foreign Plans

Are foreign plans subject to Section 409A?

Section 409A generally also applies to any deferred compensation of U.S. citizens working abroad and resident aliens in the United States. Of particular interest, amounts paid under tax equalization arrangements will be exempt from Section 409A if the payment is paid no later than the end of the second calendar year beginning after the calendar year in which a tax return is required to be filed (including extensions) relating to the tax equalization payment.

Deferral Elections

When must an initial deferral election be made?

An irrevocable election must be made, in general, no later than the end of the participant's year preceding the year for which compensation is earned. Whether or not a plan allows a participant to elect the time and form of payment of compensation is a facts and circumstances test, but any election to defer should include elections as to the form and time of payment of compensation. An election will not be considered made until the election is considered irrevocable.

When may an election to defer unvested rights be made?

For rights that are granted subject to vesting, as long as the election is made at least 12 months before vesting could occur, an election to defer such compensation may be made on or before the 30th day after the participant is granted the unvested right, as long as the participant is required to provide services for at least 12 months from the grant date.

When must the initial deferral election be made for a non-calendar fiscal year company?

If a company has a fiscal year that is not a calendar year, a plan may provide that fiscal year compensation (compensation relating to a service period matching one or more consecutive fiscal years of the company provided that no amount is payable during the service period) may be deferred at the participant's election if the election is made no later than the fiscal year preceding the first fiscal year in which services for which the compensation is payable are performed. Importantly, regular salary is not considered fiscal year compensation, and therefore the general rule for making initial deferral elections applies to salary deferrals. This can be problematic for companies with non-calendar year fiscal years where the plan year tracks the company's fiscal year.

Are there special deferral election rules for the first year of eligibility?

Yes. For the first year in which a participant becomes eligible to participate in a plan, the participant may make an initial deferral election within 30 days of the date on which he or she first becomes eligible to participate in the plan for compensation to be paid subsequent to the date of the election. If participants do not make elections as to time and form of payment, the time and form of payment must be specified within 30 days of the date on which the participant becomes eligible to participate in the plan. For compensation that is earned based on a specified performance period, such as an annual bonus, if a deferral is made in the first year of eligibility, but after the beginning of the service period, the election will be deemed to apply to compensation paid for services performed after the election as long as the portion of the compensation to which the election applies is adjusted pro rata for the days remaining in the performance period after the election is made.

What rules apply if the participant may not elect the time and form of payment?

If the participant cannot elect the time or the form of payment, the plan must specify the time or the form of payment no later than the time on which the participant first has a legally binding right to the compensation.

May a subsequent election be made to delay payment or change the form of payment with respect to compensation for which a valid initial deferral election has been made?

Yes. A subsequent election to delay a payment or to change the form of payment of an amount of deferred compensation may be made if:

- the plan requires that any such subsequent election relating to a payment that is to be made at a fixed time or pursuant to a fixed schedule may not be made less than 12 months prior to the date the first amount was scheduled to be paid;
- the plan requires that the subsequent election may not take effect until at least 12 months after the date on which the election is made; and
- the plan requires that the payment with respect to such subsequent election is made be deferred for a period of not less than five years from the date such payment would have otherwise been made.

What is a “payment” for purposes of Section 409A?

For purposes of making a subsequent election, the term “payment” refers to each separately and objectively identified amount to which a participant is entitled under a plan at a determinable date. For these purposes, a life annuity is treated as a single payment with the first date that a payment could be made with respect to the annuity as the payment date. Similarly, a series of installment payments that is not considered a life annuity is treated as a single payment, unless the plan provides that at all times the right to the series of installment payments is to be treated as a right to a series of payments for purposes of Section 409A.

For example, if a five-year installment payment is treated as a single payment and is scheduled to commence on January 1, 2008, then consistent with the five-year rule, a participant could change the time and form of payment to a lump sum on January 1, 2013, provided the other conditions for making a subsequent election were met. Conversely, if a five-year installment payment is designated as five separate payments for the years 2008 through 2013, then the participant could not change the time and form of payment to a lump-sum payment to be made on January 1, 2013, because the annual payments for 2009 through 2013 would not have been deferred for at least five years.

For a plan that was adopted and effective prior to December 31, 2006, if a designation as to how installment payments will be treated is made before December 31, 2006, such designation will be effective retroactively to the later of the date the plan was adopted or became effective.

Are there circumstances where the delay of payment will not result in a violation of Section 409A?

Yes. A plan may provide that a payment will be delayed to a date after the designated payment date and will not be treated as an impermissible payment date or a subsequent election under the following circumstances:

- the company reasonably determines that the company’s tax deduction with respect to such payment would be limited or eliminated by application of Code Section 162(m);
- the company reasonably anticipates that the making of the payment will violate a term of a loan agreement or other similar contract to which the company is a party and such violation would cause material harm to the company; and
- the company reasonably anticipates that the making of the payment will violate Federal securities or other applicable law.

Separation Pay Plans (Severance)

What is a “separation pay plan” for purposes of Section 409A?

A “separation pay plan” is any plan or part of a plan that provides for compensation where one of the conditions to the right to receive the payment is a separation from service, whether voluntary or involuntary. It continues to be a separation pay arrangement even if the right to receive

the payment is conditioned on the execution of a release of claims, noncompetition or nondisclosure provisions, or similar requirements. However, it is not a separation pay plan if the payment acts as a substitute for, or replacement of, compensation under a separate plan.

What is the general rule regarding separation pay plans?

Generally, the right to a payment on a separation of service may be deferred compensation. However, three exceptions do not result in deferred compensation:

- *Limited Severance.* A plan that provides for separation pay upon an *actual involuntary separation* from service or under a window program (as described below) does not provide for deferred compensation if the plan provides that the separation pay does not exceed twice the lesser of: (a) the compensation from the two calendar years before the calendar year in which the separation from service occurred, or (b) the Code Section 401(a)(17) amount (\$210,000 for 2005). It also must be paid no later than December 31 of the second calendar year following the calendar year in which the separation from service occurs.
- *Reimbursements.* A plan that entitles a participant whose employment has been terminated for a limited period of time to reimbursements that are otherwise: (a) excludable from gross income, (b) for expenses that can be deducted as business expenses under Code Sections 162 or 167, (c) for reasonable outplacement services or moving expenses incurred and directly related to the termination of services, (d) for payments of medical expenses incurred or paid by the participant, but not reimbursed and allowable as a deduction under Code Section 213, or (e) an in-kind benefit or company-paid benefit to the person providing goods and services to the participant will not be deferred compensation.
- *Collectively Bargained Programs.* Programs that provide for separation pay upon an *actual involuntary separation* from service or a window program do not result in deferred compensation under Section 409A if the program is contained within a collective bargaining agreement and subject to an arm's-length negotiation between employee representatives and one or more employers, and the circumstances surrounding the agreement evidence good faith bargaining between adverse parties over the separation pay.

Is an individually negotiated severance arrangement subject to the timing and form of payment rules of Section 409A?

Where separation pay due to an involuntary termination of employment has been subject to bona fide, arm's-length negotiation, a participant may elect as to the time and form of payment on or before the date the participant obtains a legally binding right to the payment without running afoul of Section 409A. This exemption may not apply to a participant's resignation for "good reason" because the IRS view is that this gives the participant too much control over the time of payment. Also, this exemption does not remove the requirement to comply with other rules of Section 409A (for example, the six-month delay for payments to key employees).

What is a window program?

A company establishes a window program by providing separation pay in connection with a separation from service for no more than one year to participants who separate from service during that window period or during that period for specific circumstances.

Does Section 409A apply to payments of small amounts?

No. Section 409A may not apply to payments, reimbursements, or benefits that do not exceed \$5,000 in the aggregate, although the proposed regulations are somewhat vague on this point.

What is a “limited period of time” and why is it important?

For purposes of separation pay plans, a “limited period of time” refers to when expenses may be incurred and the period during which reimbursements must be paid. It may not extend beyond December 31 of the second calendar year following the calendar year in which the separation from service occurred.

Plan Aggregation

Must companies aggregate similar type plans?

Yes. Under the regulations, companies must aggregate similar-type plans and treat them as single plans. For example, the regulations require that companies treat all amounts deferred under all account balance plans (such as a typical defined contribution deferred compensation plan) as deferred under a single plan. The same concept applies to non-account balance plans (such as a typical defined benefit supplemental executive retirement plan), all separation payment plans, and other plans. However, if a participant participates in one plan as an employee and another plan as an independent contractor, the plans are not aggregated. Further, there is no plan aggregation if a director participates in a director plan and an employee plan.

Establishment of a Plan

When does a company establish a plan?

A plan is established on the latest of the plan’s adoption date, effective date, or date on which the material terms are set forth in writing. The material terms of the plan include the amount, method, or formula to calculate the amount of deferred compensation and the timing of the payment.

Definition of Substantial Risk of Forfeiture

When is a participant’s compensation subject to a substantial risk of forfeiture?

Under Section 409A, amounts deferred under a plan generally will not be taxable while subject to a substantial risk of forfeiture. A substantial risk of forfeiture exists if a participant will not have the right to receive the compensation until either the individual performs substantial

services in the future, or a condition related to the purpose of the compensation occurs. In addition, the possibility of forfeiture must be substantial.

Are there circumstances where no substantial risk of forfeiture will be recognized?

Yes. The following are examples of circumstances where no substantial risk of forfeiture will be recognized:

- a requirement to refrain from performing services (for example, a noncompete provision);
- extensions of substantial risks of forfeiture such as when a participant or employer elects to extend an existing risk of forfeiture by a number of years (generally these are implemented in not-for-profit deferred compensation plans and are referred to as “rolling risks of forfeiture”);
- additions of substantial risks of forfeiture on amounts already earned (for example, salary) unless the amount at risk is materially greater than the amount already earned;
- immediately exercisable options where the optionee will receive substantially vested stock; or
- the individual providing services owns a significant amount of the company’s stock and, based on certain facts and circumstances, it is unlikely that the company would enforce the substantial risk of forfeiture.

Definition of Performance-Based Compensation

Why is it important that compensation be performance-based compensation?

A special initial deferral rule applies to performance-based compensation paid for services performed over 12 months. This special rule provides that an individual’s initial deferral election for such performance-based compensation may be made at least six months before the end of the 12-month period.

What is performance-based compensation?

To be performance-based compensation, the amount or payment of the compensation must be contingent on satisfaction of written organizational or individual performance criteria. In addition, the criteria must be established no later than 90 days after the performance period begins. Finally, it must not be known at the outset that such criteria will be satisfied.

May the organizational or individual performance criteria be subjective in nature?

Yes. The criteria may be subjective in nature if the following requirements are satisfied:

- The criteria must relate to the performance of the participant either on an individual basis or on a group basis taking into account the individual's performance.
- Satisfaction of the criteria is determined by an independent person (that is, someone other than the participant who may receive the compensation, a family member of such individual, or someone who is subordinate to or whose compensation is controlled by such individual or family member).

When will equity compensation be considered performance-based compensation?

Equity compensation will be considered performance-based compensation if:

- the compensation is based *solely* on an increase in the value of the company or the company's stock after the date of grant;
- the compensation is not based solely on such an increase (for example, a stock purchase right with an exercise price below the fair market value of the company's stock on the date of grant) but the portion of the compensation solely tied to the increase in the value of the company or the company's stock is performance-based compensation; or
- the equity compensation is subject to a condition, such as performance-based vesting, that would otherwise make the compensation performance-based.

Definitions of Service Provider and Service Recipient

Why is it important whether a participant has separated from service?

Section 409A provides that a plan may generally permit a payment to be made upon a separation from service. However, in the case of a payment to a key employee, a plan cannot permit a payment for at least six months following the separation from service. To account for this six-month delay, a plan may provide that the initial commencement date of the payments will be delayed for six months or that a catch-up payment will be made at the expiration of the six-month period.

Who is considered a service provider/participant for purposes of the regulations?

In general, a service provider/participant includes individuals, corporations, S corporations, personal service corporations, qualified personal service corporations, and certain other non-corporate entities. Section 409A, however, will not apply to a plan if the service provider/participant uses an accrual method of accounting as opposed to a cash method of accounting. This exception applies because an accrual method taxpayer generally recognizes income at the time the compensation is earned, as opposed to when it is paid.

Are there any special rules for independent contractors?

Yes. Section 409A does not apply to amounts deferred by an independent contractor if the independent contractor is providing “significant” services to each of two or more companies that are not related to each other or the independent contractor. Whether the services provided are significant depends on the facts and circumstances.

The rules for determining whether the companies are unrelated to each and to the independent contractor are fairly detailed. However, the regulations generally provide that an independent contractor will be deemed to be related under two circumstances: (a) the independent contractor is an officer of the company (or holds a substantially similar position for a non-corporate service recipient), or (b) the independent contractor provides management services to the company. Management services include services involving the direction or control of the financial or operational aspects of the company or investment advisory services provided to a company whose primary trade or business includes the management of financial assets for its own account (for example, a hedge fund or REIT).

What is considered a service recipient?

A service recipient/company includes the entity for whom the services are performed and who has the legal obligation to pay for the services. In addition, a service recipient/company includes all persons aggregated with such entity under special controlled group rules.

Definition of Separation from Service

What is a separation from service for purposes of Section 409A?

A participant separates from service upon death, retirement, or termination of employment.

Under what circumstances will a termination of employment occur?

Whether a termination of employment has occurred is based on facts and circumstances. However, no termination of employment will occur:

- while a participant is on military leave, sick leave, or some other bona fide leave of absence if the period does not exceed six months or does exceed six months but the individual has a legal or contractual right to be rehired;
- if the participant continues to provide services as an employee generally on a basis which exceeds a 20 percent of time and compensation threshold; or
- if the participant continues to provide services in a non-employee capacity on a basis which exceeds a 50 percent of time and compensation threshold.

Employees who continue on the payroll when working less than 20 percent of full time may cause issues under the proposed regulations.

When will an independent contractor experience a separation from service for purposes of Section 409A?

An independent contractor separates from service when the service contract expires and the expiration constitutes a good faith and complete termination of the relationship (for example, the company does not intend to renew the contract and the independent contractor has been eliminated as a possible provider of services).

For purposes of the six-month delay rule, who is a “key employee”?

A “key employee” is an employee of a publicly traded company who at any time during the 12-month period ending on the determination date chosen by the company is a key employee under the top-heavy rules of the Code. If an employee would be considered a key employee as of the determination date, the employee will be considered a key employee for the 12-month period beginning on the fourth month following the end of the 12-month determination period.

Payment Date Requirements

What are the permissible events pursuant to which an amount of deferred compensation may be paid?

The requirements of Section 409A are met only if the plan provides that an amount of deferred compensation may be paid only on account of one or more of the following:

- The participant’s separation from service;
- The participant becoming disabled;
- The participant’s death;
- A time (or pursuant to a fixed schedule) specified under the plan;
- A change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the assets of the corporation; or
- The occurrence of an unforeseeable emergency.

May a plan designate alternative payment dates or schedules?

Generally, yes. If a plan designates that deferred compensation is to be paid pursuant to a determinable fixed date or schedule following an allowable payment event (for example, separation from service, or death), then the date or schedule must generally apply uniformly regardless of when the payment event occurs. However, the proposed regulations allow a plan to provide alternative schedules for payments occurring before or after a single date. For example, a plan could provide for lump-sum distribution upon termination before age 65 or installments upon termination on or

after age 65. This rule could be of significant value, for instance, for payments triggered by a change in control, in which payments typically are made in a lump sum.

Does a payment need to be made exactly on the designated payment date?

No. A payment will be treated as made on the designated payment date if the payment is actually made at such date or any later point in the calendar year or, if later, within two-and-a-half months after the designated payment date. It is also possible to delay the actual payment without violating the requirement of payment on a designated date in certain situations involving administrative difficulty making the payment or financial inability of the payer to make the payment.

What requirements apply to payments made on a specified time or fixed schedule?

The proposed regulations provide that amount and time of payments under a fixed schedule or specified time must be objectively determinable at the time of deferral. The time of deferral is objectively determinable if the plan designates a calendar year or years (not necessarily an exact date) in which the amounts are payable. If, however, the specific payment date in a calendar year is not objectively determinable, then the payment will be deemed to be made on January 1 of such year for purposes of applying timing restrictions related to subsequent deferrals.

The amount is objectively determinable if specifically identified or made pursuant to a nondiscretionary formula (for example, 50 percent of account balance).

The proposed regulations also permit a scheduled payment to begin on a specified vesting date. For example, deferred payment could be structured to commence on the earlier of three years of continued service or the occurrence of an initial public offering.

What must plans include regarding the 6-month delay of payments to key employees?

The plan must specify the manner in which it will implement the six-month delay upon separation from service for key employees. For example, a plan could state that payments during the six-month period are accumulated and paid upon another date or fixed schedule (for example, beginning on the seventh month) or all installments to a key employee are delayed six months. Plan sponsors can amend such provisions at any time; however, such amendments cannot become effective for 12 months, except prior to an initial public offering, in which case the amendment can become effective immediately.

When may deferred compensation be paid on account of an unforeseeable emergency?

Payments upon the occurrence of an “unforeseeable emergency” are allowable only upon severe financial hardship of the participant or a beneficiary resulting from illness or accident or other similar extraordinary and unforeseeable circumstances from events beyond the control of the participant or the participant’s beneficiary (for example, foreclosure or eviction). Distributions are limited to the amount necessary to satisfy the need and may not be made if the emergency can be relieved by insurance, liquidation of other assets, or cessation of deferrals under the plan.

Accordingly plan administrators will be required to make a determination of the need and other available assets before making a distribution under this rule.

Other than in cases of unforeseeable emergency, are there other circumstances when deferred compensation payments may be accelerated?

Yes. Payments may be accelerated under the following circumstances:

- Payment to someone other than the participant of amounts required to be paid as the result of a domestic relations order (as defined in the tax-qualified retirement plan rules);
- Payment necessary to comply with divestitures required by conflict of interest rules;
- If taxes are due upon a vesting event under a Code Section 457 plan, payment may be made in an amount necessary to pay the required taxes;
- Payment by December 31 of the calendar year in which a participant separates from service (or alternatively, March 15 of the year following separation from service, if such separation occurs after October 15) of an entire account balance that is less than \$10,000, so long as the plan from which the payment is made terminates and all other aggregated plans for that participant also terminate;
- Payment of employment taxes related to the plan
- Payment of income taxes due to required income inclusion under Section 409A; or
- Payment after termination of the plan. In two objective circumstances (following a corporate dissolution or a corporate bankruptcy), payment can be made if the plan termination is done within 12 months of the dissolution or bankruptcy. If the plan is terminated within 30 days before or 12 months after a change-in-control event, amounts may be paid from the plan as long as they are paid between 12 and 24 months from the date of plan termination. However, any payments that would otherwise have been payable during the first 12 months after plan termination may still be made then. Further, if a plan is terminated in connection with a change-in-control event, a similar plan that covers the same participants may not be adopted within five years of termination of the plan. All aggregated plans must be terminated together.

In addition to those events listed above under which acceleration of payment is permissible, the proposed regulations detail two circumstances that are not considered accelerations. First, it is acceptable to specify an acceleration event at or before the time of deferral. For example, a plan could provide for payment to be made in 10 annual installments with any remaining installments paid in a single lump sum upon death or disability. Second, if a payment is subject to a substantial risk of forfeiture and the company waives the condition that gives rise to the substantial risk of forfeiture, it is not considered an impermissible acceleration. For example, if a plan participant with a 10-year vesting schedule terminates employment after five years, if the company waives the vesting schedule and makes immediate payment to the participant, that would be permitted.

May payments be made upon disability?

Distributions are permitted for disability only if the participant is “disabled” for purposes of Social Security or is receiving disability benefits for at least three months under a group plan covering other participants.

May payments be made on a change in control?

The plan may permit distributions upon a “change in control” if any of the following changes occur: (a) the plan participant’s employer or service recipient, (b) the corporation liable for the deferred compensation payment, or (c) the parent corporation of the employer or service recipient. An important plan requirement is that the “change in control” must be objectively determinable under the plan terms (that is, the plan may not permit discretion to determine whether or not there has been a “change in control”).

A change in control also includes:

- a change in effective control caused by a person, or persons acting as a group, acquire stock within a 12-month period that consists of 35 percent or more of the total voting power of all of the corporation’s stock;
- a change in effective control caused by a majority of corporation’s board of directors being replaced within a 12-month period by directors who are not endorsed by the sitting board of directors; or
- the acquisition, within a 12-month period, by a person, or persons acting as a group, of 40 percent or more of the gross fair market value of the corporation’s assets (determined without regard to any liabilities associated with the assets). The proposed regulations are very clear that transfers of assets to related corporations will not constitute a change-in-control event.

How are escrow or earn-out payments treated under Section 409A?

The proposed regulations provide specific relief from Section 409A for escrow or earn-out arrangements often implemented in change-in-control situations. Compensation related to stock of the company, the payment of which is delayed pursuant to an escrow or earn-out arrangement, is deemed to satisfy the fixed payment schedule rule if such compensation is paid on the same terms and conditions applicable to shareholders generally. Such compensation generally must be paid out no later than five years after the change in control. This rule would apply in situations where, for example, merger consideration paid with respect to participant restricted stock is held in an escrow account and paid out only upon the attainment of company performance goals, provided that all shareholders are subject to the same restrictions and the performance period is no longer than five years.

Grandfathered Plans

What is a grandfathered plan?

Plans that were adopted before Section 409A became effective generally may be “grandfathered” so that they are not subject to Section 409A with respect to deferrals made before January 1, 2005. However, if such a plan is materially modified, it becomes subject to Section 409A.

What modifications to a grandfathered plan are material for purposes of Section 409A?

For this purpose, a plan will be considered materially modified if a benefit or right that existed as of October 3, 2004, is materially enhanced or a new material benefit or right is added, and the enhancement or addition affects amounts earned and vested before January 1, 2005. Amending a plan to comply with Section 409A will not be a material modification.

An example of a material modification is an amendment to add a “haircut” provision under which amounts vested and earned prior to January 1, 2005, may be distributed to the plan participant if he or she forfeits a percentage (typically 10 or 15 percent) of the account balance. On the other hand, the removal of a haircut provision would not be a material modification, as it reduces an existing benefit.

For amounts earned and vested before January 1, 2005, it will not be a material modification for an employer to exercise discretion over the time and form of payment if permitted to do so by the terms of the plan as in effect on October 3, 2004. It also will not be a material modification for a participant to exercise a right, such as a “haircut” provision similar to that mentioned above, if the right was permitted by the terms of the plan as in effect on October 3, 2004.

The adoption of a new plan or the grant of an additional benefit under an existing plan after October 3, 2004, and before January 1, 2005, is presumed to constitute a material modification. However, the presumption can be rebutted by demonstrating that the adoption or addition is consistent with the employer’s historical compensation practices.

If the additional benefit consists of the deferral of an additional amount that was not permitted to be deferred as of October 3, 2004, it will be considered a material modification only as to the additional deferral, but only if the plan specifically identifies the additional deferral and provides that it is subject to Section 409A.

May grandfathered plans be terminated and assets distributed throughout the extended good faith compliance period without it being considered a material modification?

No. The proposed regulations have not extended the period of time during which grandfathered plans may be terminated and the assets distributed without constituting a material modification. In accordance with Notice 2005-1, grandfathered plans may be terminated and the assets distributed before December 31, 2005, without it being treated as a material modification if all

amounts deferred under the plan are included in income in the taxable year in which the termination occurs. The termination and distribution of assets must occur in the same taxable year.

Neither the termination of a plan nor the cessation of deferrals under a plan that occurs in accordance with the plan terms is a material modification for purposes of the Section 409A rules. An amendment to stop future deferrals is not a material modification for purposes of the Section 409A rules.

Amending a plan to provide participants with an election to terminate participation or continue deferrals will constitute a material modification. However, Notice 2005-1 permits participants to cancel their deferral elections made in 2005 or cancel their participation in a plan through December 31, 2005.

Can an accidental material modification be cured?

The proposed regulations provide that modifications that inadvertently will result in treatment as a material modification can be rescinded by the earlier of (a) a date before the discretionary right granted by the modification is exercised, or (b) the last day of the calendar year in which the modification occurred.

Linked Plans

Do the proposed regulations impact plans that are linked to qualified plans?

Some plans base deferral amounts on a formula that takes into consideration the amount deferred under a qualified plan. As a result, adjustments to the deferral elections or matching or other contributions under the qualified plan have an impact on the amount deferred under the nonqualified plan, which could cause the plan to violate Section 409A. The proposed regulations refer to these as “linked plans.”

The proposed regulations provide some relief with respect to linked plans, specifically with respect to benefit limitations under qualified plans that affect the linked plan, and with respect to the acceleration of payment rules. The proposed regulations generally are intended to permit the qualified plan to continue operations in accordance with the rules governing such plans without its normal operations causing the linked plan to violate Section 409A, although some plan changes may be necessary.

What are the deferral election rules for linked plans?

Where a qualified plan’s terms, either because of a formula used in the initial linked plan to determine benefits without regard to Code limits or by an offset determined by some or all of the benefits provided under the qualified plan, operate to determine the amount deferred under a linked plan, the operation of the qualified plan with respect to changes in benefit limitations applied to the qualified plan under applicable laws or the Code is not a deferral election even if such operation results in an increase in the amounts deferred under the linked plan, as long as such operation does not otherwise result in a change in the time or form of payment under the plan. Subsidized or

ancillary benefits, adjustments pursuant to Code Section 402(g), and elective deferrals and after-tax contributions with respect to the qualified plan also do not constitute deferral elections provided that these actions do not otherwise affect the time or form of payment under the linked plan.

What relief do the proposed regulations provide to linked plans with respect to the acceleration of payments?

Where a change to a qualified plan results in a decrease in the amounts deferred under the linked plan (including by virtue of amendment or the cessation of accruals under the qualified plan), the change generally will not be considered an impermissible acceleration of payment under the linked plan.

Does a specific exception exist for linked plans with respect to the acceleration of payment prohibition?

A participant's action or inaction with respect to his or her elective deferrals or after-tax contributions to a qualified plan that impacts the amounts credited to the participant's account as matching amounts (or other amounts contingent on the participant's elective deferrals or after-tax contributions) will not be an impermissible payment acceleration if the adjustment does not result in an increase or decrease in the amounts deferred by the participant under all linked plans in which he or she is participating in excess of an amount equal to the Code Section 402(g) limit on elective deferrals for the relevant calendar year.

May payment elections under a qualified plan continue to govern payments under the linked plan?

On or before December 31, 2006, payment elections under a linked plan may continue to be governed by payment elections under a qualified plan, if the payment election is in accordance with the terms of the linked plan in effect as of October 3, 2004. After December 31, 2006, elections under a qualified plan controlling the form and timing of payments under a linked plan must be eliminated.

Circular 230 Compliance: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this memorandum is not intended or written to be used, and cannot be used, for the purpose of (a) avoiding penalties under the Internal Revenue Code, or (b) promoting, marketing or recommending to another party any transaction or matter addressed herein.

If have any questions about Section 409A, please contact any member of the Employee Benefits and Compensation Group.

Name	Location	Phone Number	E-Mail Address
John Aguirre	Palo Alto	(650) 565-3603	jaguirre@wsgr.com
Melody Barker	San Francisco	(415) 947-2029	mbarker@wsgr.com
Linda Barrett	San Francisco	(415) 947-2044	lbarrett@wsgr.com
Ralph Barry	San Diego	(858) 350-2344	rbarry@wsgr.com
Jessica Bliss	Palo Alto	(650) 849-3470	jbliss@wsgr.com
Madeleine Boshart	San Francisco	(415) 947-2057	mboshart@wsgr.com
Jessica Janov	San Diego	(858) 350-2351	jjanov@wsgr.com
Thuy Le	Palo Alto	(650) 849-3329	tle@wsgr.com
John Ludlum	Salt Lake City	(801) 993-6410	jludlum@wsgr.com
Cheryl Masters	Palo Alto	(650) 461-6206	cmasters@wsgr.com
Scott McCall	Palo Alto	(650) 320-4547	smccall@wsgr.com
Michael Montfort	Reston	(703) 734-3155	mmontfort@wsgr.com
Roger Stern	Palo Alto	(650) 320-4818	rstern@wsgr.com
David Thomas	Palo Alto	(650) 849-3261	dthomas@wsgr.com
Michelle Wallin	Palo Alto	(650) 565-3620	mwallin@wsgr.com

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