

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2007-29, page 1223.

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 642, 1274, 1288, and other sections of the Code, tables set forth the rates for May 2007.

Announcement 2007-44, page 1238.

This announcement provides that for purposes of the Archer Medical Savings Account (Archer MSA) pilot program under section 220(j)(2) of the Code, 2005 and 2006 are not cut-off years.

EMPLOYEE PLANS

T.D. 9321, page 1123.

Final regulations set forth guidance on the application of section 409A to nonqualified deferred compensation plans. The regulations provide a definition of a nonqualified deferred compensation plan subject to section 409A, including rules related to the statutory effective date, and rules governing initial and subsequent deferral elections, the establishment of the time and form of payment, and the acceleration of payments under a plan. Notice 2005-1 obsoleted in part. Notice 2006-4 superseded in part. Notice 2006-64 superseded for taxable years on or after January 1, 2008.

EXEMPT ORGANIZATIONS

Announcement 2007-46, page 1239.

The IRS has revoked its determination that World Project, Inc., of Brooklyn, NY; Izaak Walton League of America, Calumet Re-

gion Chapter, of Dolton, IL; Greenbriar Club, Inc., of Clearwater, FL; Cunningham Family Foundation of West Jordan, UT; Roxbury Insurance Company of Los Angeles, CA; and Wishes Are Forever Foundation of Salt Lake City, UT, qualify as organizations described in sections 501(c)(3) and 170(c)(2) of the Code.

ADMINISTRATIVE

Rev. Proc. 2007-31, page 1225.

Qualified mortgage bonds; mortgage credit certificates; national median gross income. Guidance is provided concerning the use of the national and area median gross income figures by issuers of qualified mortgage bonds and mortgage credit certificates in determining the housing cost/income ratio described in section 143(f) of the Code. Rev. Proc. 2006-20 obsoleted in part.

Announcements of Disbarments and Suspensions begin on page 1227.
Finding Lists begin on page ii.

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by

applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are compiled semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations,

court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

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Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2007. See Rev. Rul. 2007-29, page 1223.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of May 2007. See Rev. Rul. 2007-29, page 1223.

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted applicable federal long-term rate is set forth for the month of May 2007. See Rev. Rul. 2007-29, page 1223.

Section 409A.—Inclusion in Gross Income of Deferred Compensation Under Nonqualified Deferred Compensation Plans

26 CFR 1.409A-6: Application of section 409A and effective dates.

T.D. 9321

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Application of Section 409A to Nonqualified Deferred Compensation Plans

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations regarding the application of section 409A to nonqualified deferred compensation plans. The final regulations are necessary to clarify and explain the rules governing the application of section

409A to nonqualified deferred compensation plans. The regulations affect service providers receiving amounts of deferred compensation and the service recipients for whom the service providers provide services.

FOR FURTHER INFORMATION CONTACT: Stephen Tackney, (202) 927-9639 (not a toll-free number).

DATES: *Effective Date:* These regulations are effective April 17, 2007.

Applicability Dates: For dates of applicability, see §1.409A-6(b).

SUPPLEMENTARY INFORMATION:

Background

Section 409A was added to the Internal Revenue Code (Code) by section 885 of the American Jobs Creation Act of 2004, Public Law 108-357 (118 Stat. 1418). Section 409A generally provides that unless certain requirements are met, 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 gross income. Section 409A also includes rules applicable to certain trusts or similar arrangements associated with a nonqualified deferred compensation plan, where such arrangements are located outside of the United States or are restricted to the provision of benefits in connection with a decline in the financial health of the sponsor.

On December 20, 2004, the IRS issued Notice 2005-1 (published as modified on January 6, 2005, in 2005-1 C.B. 274), setting forth initial guidance with respect to the application of section 409A, and supplying transition guidance pursuant to a statutory directive. A notice of proposed rulemaking (REG-158080-04, 2005-2 C.B. 786 [70 FR 57930]) was published in the **Federal Register** on October 4, 2005. See §601.601(a)(3). A public hearing was conducted on January 25, 2006. In addition, the IRS received written and electronic comments responding to the notice of proposed rulemaking. After consider-

ation of all the comments, the proposed regulations are adopted as amended by this Treasury decision. The amendments are discussed in this preamble.

The Treasury Department and the IRS have also issued six additional notices providing transition guidance with respect to section 409A: (1) Notice 2005-94, 2005-2 C.B. 1208 (transition guidance with respect to 2005 reporting and withholding obligations); (2) Notice 2006-4, 2006-3 I.R.B. 307 (transition guidance with respect to certain outstanding stock rights); (3) Notice 2006-33, 2006-15 I.R.B. 754 (transition guidance with respect to the application of section 409A(b)); (4) Notice 2006-64, 2006-29 I.R.B. 88 (interim guidance regarding payments necessary to meet Federal conflict of interest requirements); (5) Notice 2006-79, 2006-43 I.R.B. 763 (additional transition relief); and (6) Notice 2006-100, 2006-51 I.R.B. 1109 (transition guidance with respect to 2005 and 2006 reporting and withholding obligations). See §601.601(d)(2). For a discussion of the continued applicability of these notices, see the **Effect on Other Documents** section of this preamble.

Explanation of Provisions and Summary of Comments

I. Structure and Format of Regulations

The final regulations generally adopt the structure and format of the proposed regulations. A table of contents has been included in the final regulations, as well as several additional sets of examples addressing various topics.

II. Definition of Nonqualified Deferred Compensation Plan

A. Excluded plans

The final regulations exclude the types of plans described in section 409A(d)(1) from the definition of a nonqualified deferred compensation plan, as well as certain other arrangements that were also set forth in the proposed regulations. Accordingly, the final regulations generally provide that a nonqualified deferred compensation plan for purposes of section 409A

does not include a qualified plan, a *bona fide* sick leave or vacation plan, a disability plan, a death benefit plan, or certain medical expense reimbursement arrangements.

The final regulations clarify that the exemption from coverage under section 409A for certain welfare plans does not apply to medical expense reimbursements that constitute taxable income to the service provider. The coverage exemption applies only to arrangements that provide benefits that are excludable from gross income under section 105 or section 106.

Several commentators requested clarification of when a leave program will be treated as a *bona fide* sick leave or vacation leave plan for purposes of section 409A. Another commentator requested a clarification of the definition of a compensatory time plan. Because the definitions of these terms may raise issues and require coordination with the provisions of section 451, section 125, and, with respect to certain taxpayers, section 457, the final regulations do not address these issues.

Notice 2005-1, Q&A-6 provides that, until further guidance, taxpayers whose participation in a nonqualified deferred compensation plan would be subject to section 457(f) may rely on the definitions of *bona fide* vacation leave, sick leave, compensatory time, disability pay, or death benefit plan applicable for purposes of section 457(f) as also being applicable for purposes of section 409A. Until further guidance, such taxpayers may continue to rely on such definitions for purposes of section 409A.

One commentator requested that a qualified employer plan for purposes of the exclusion from section 409A include certain plans covered by section 402(d) (certain plans with a foreign-situs trust treated as qualified plans with respect to the taxation of the participants and beneficiaries) and retirement plans described in section 1022(i)(2) of the Employee Retirement Income Security Act of 1974, as amended (certain Puerto Rican retirement plans). The final regulations adopt this suggestion.

B. Section 457 plans

The final regulations provide that section 409A is not applicable to an eligible deferred compensation plan under section 457(b), but may be applicable to a de-

ferred compensation plan that is subject to section 457(f). Commentators requested clarification of the application of the exception in the proposed regulations from the definition of deferred compensation referred to as the short-term deferral rule (described in section III.C.1 of this preamble) to a section 457(f) plan. As discussed below, a right to deferred compensation generally refers to a legally binding right in one taxable year to compensation that is or may be payable in a subsequent taxable year. For purposes of determining the time of payment, the term “payment” generally refers to an actual or constructive payment of cash or property. However, the final regulations provide that for purposes of the short-term deferral rule, an amount is treated as paid when it is included in income under section 457(f) whether or not an actual or constructive payment occurs. Accordingly, where the income inclusion under section 457(f) stems from the lapse of a substantial risk of forfeiture that is also treated as a substantial risk of forfeiture for purposes of section 409A, the amount included in income will be considered a short-term deferral for purposes of section 409A. However, the right to earnings on amounts that have previously been included under section 457(f) will be deferred compensation for purposes of section 409A unless the right to the earnings independently satisfies the requirements for an exclusion.

C. Arrangements with independent contractors

The final regulations provide that section 409A generally does not apply to an amount deferred under an arrangement between a service provider and an unrelated service recipient if during the service provider’s taxable year in which the service provider obtains a legally binding right to the deferred amount the service provider is actively engaged in the trade or business of providing services (other than as an employee or as a director of a corporation), and provides significant services to two or more service recipients to which the service provider is not related and that are not related to one another.

The final regulations retain the safe harbor in the proposed regulations, under which a service provider is deemed to be providing significant services to two or

more such service recipients for this purpose if the revenues generated from the services provided to any service recipient or group of related service recipients during such taxable year do not exceed 70 percent of the total revenues generated by the service provider from the trade or business of providing such services. Commentators expressed concern that the safe harbor did not permit independent contractors to know in advance whether the arrangements under which an independent contractor deferred compensation during a taxable year would be subject to section 409A. Commentators requested certain look-back periods, including the ability to use averaging over the previous three to five years, or to satisfy the 70 percent threshold over a certain portion of the previous three to five years. The Treasury Department and the IRS are concerned that the suggested rules would allow service providers to engage in strategic behavior to ensure that activity in certain years would be exempt from section 409A. Accordingly, the final regulations adopt an additional safe harbor that provides that a service provider that has actually met the 70 percent threshold in the three immediately previous years is deemed to meet the 70 percent threshold for the current year, but only if at the time the amount is deferred the service provider does not know or have reason to anticipate that the service provider will fail to meet the threshold in the current year.

In response to comments, the final regulations provide that if an independent contractor qualifies for the safe harbor for exclusion from coverage under section 409A with respect to arrangements with unrelated service recipients, an arrangement between the independent contractor and a service recipient related to the independent contractor will not be subject to section 409A if the arrangement, and the practices under the arrangement, are *bona fide*, arise in the ordinary course of business, and are substantially the same as the arrangements and practices (such as billing and collection practices) applicable to one or more unrelated service recipients to whom the independent contractor provides substantial services and that produce a majority of the total revenue that the independent contractor earns from the trade or business of providing such services during the year.

The final regulations further clarify that if at the time the legally binding right to the payment arose, the arrangement was not subject to section 409A because the service provider was an independent contractor that was eligible for this exclusion from coverage under section 409A, the amount deferred under the arrangement during that taxable year (and earnings credited to the deferred amount) will not become subject to section 409A in a later year if the service provider becomes an employee, independent contractor, or other type of service provider subject to the rules of section 409A.

Commentators also requested that a service recipient be permitted to rely upon a representation of an independent contractor that the independent contractor meets the exclusion requirements, so that a service recipient will know whether it is subject to the reporting requirements with respect to amounts deferred subject to section 409A. The Treasury Department and the IRS are continuing to study this issue.

D. Anti-abuse rule

If a principal purpose of a plan is to achieve a result with respect to a deferral of compensation that is inconsistent with the purposes of section 409A, the Commissioner may treat the plan as a nonqualified deferred compensation plan for purposes of section 409A.

III. Definition of Deferral of Compensation

A. In general

The final regulations provide that a nonqualified deferred compensation plan is a plan that provides for the deferral of compensation. The final regulations further provide that a plan generally provides for the deferral of compensation if, under its terms and the relevant facts and circumstances, a service provider has a legally binding right during a taxable year to compensation that, pursuant to its terms, is or may be payable to (or on behalf of) the service provider in a later year. For this purpose, an amount generally is payable at the time the service provider has a right to currently receive a transfer of cash or property, including a transfer of property includible in income under section 83, the economic benefit doctrine or section

402(b). Accordingly, a taxable transfer of an annuity contract is treated as a payment for purposes of section 409A.

The definition of deferral of compensation in the final regulations excludes the condition that the amount not be actually or constructively received and included in income during the taxable year, because that language might cause confusion with respect to the applicable rules governing deferral elections and the prohibition on the acceleration of payments. For example, if a service provider has made an irrevocable election to defer an amount of his or her salary to a future year, that amount is treated as deferred compensation regardless of whether the service recipient actually pays such amount to the service provider during the year in which the services are performed. Any early payment of the deferred compensation (or any right to receive such an early payment) generally would constitute an impermissible acceleration of the payment of the deferred amount.

For this purpose, a plan will be treated as providing for a payment to be made in a subsequent year whether the plan explicitly so provides (including through a service provider election) or the deferral condition is inherent in the terms of the contract. Where the parties have agreed that a payment will be made upon an event that could occur after the year in which the legally binding right to the payment arises, the plan generally will provide for a deferral of compensation (unless otherwise excluded under a specific exception, such as the short-term deferral rule).

For example, if a plan provides a service provider a right to a payment upon separation from service, the plan generally will result in a deferral of compensation regardless of whether the service provider separates from service and receives the payment in the same year as the grant, because under the plan the payment is conditioned upon an event that may occur after the year in which the legally binding right to the payment arises. Similarly, if an arrangement such as a stock option or stock appreciation right not otherwise excluded from coverage under section 409A provides a right to a payment for a term of years where the payment could be received during the short-term deferral period or a subsequent period but is not otherwise includible in income until

paid, the arrangement will provide for deferred compensation even though the service provider could receive the payment during the short-term deferral period (for example, by exercising the stock option or stock appreciation right). However, where a plan does not specify a payment date, payment event or term of years, (or specifies a date or event certain to occur during the year in which the services are performed), the plan generally will not provide for the deferral of compensation if the service provider actually or constructively receives the payment within the short-term deferral period.

The proposed regulations provided that earnings on deferred amounts are generally treated as deferred compensation for purposes of section 409A. Under the final regulations, whether a deferred amount constitutes earnings on an amount deferred, or actual or notional income attributable to an amount deferred, is determined under the principles defining income attributable to the amount taken into account under §31.3121(v)(2)-1(d)(2).

A commentator requested clarification of whether a payment for a noncompetition agreement could be subject to section 409A. Because such a payment would occur in connection with the performance or nonperformance of services, and a covenant not to compete does not create a substantial risk of forfeiture for purposes of section 409A, a legally binding right obtained in one year to a payment in a subsequent year in connection with a noncompetition agreement generally would constitute deferred compensation.

B. Legally binding right

The regulations define deferral of compensation in the context of a legally binding right to a payment of compensation in a future taxable year. Commentators requested clarification of the standard that would be used to determine whether a service provider has a legally binding right. A legally binding right includes a contractual right that is enforceable under the applicable law or laws governing the contract. A legally binding right also includes an enforceable right created under other applicable law, such as a statute.

One commentator suggested that no legally binding right exists where the payment is made only upon the realization

of gain from a particular investment. For example, the commentator argued that a bonus payable based upon the amount that a service provider obtains in selling property should not be treated as granting the service provider a legally binding right to the payment until the property is sold. In such a situation, however, the requirement that the property be sold is a condition to the right to the payment, but the right to the payment is still a legally binding right. The service recipient could not simply revoke the promise, sell the property, and not pay the bonus. However, the condition that the property be sold before the service provider becomes entitled to payment may constitute a substantial risk of forfeiture, depending on the specific facts and circumstances.

C. Short-term deferrals

1. In general

Subject to the modifications described in this section III.C of the preamble, the final regulations generally adopt the short-term deferral rule that was contained in the proposed regulations. Under the short-term deferral rule, a deferral of compensation does not occur for purposes of section 409A if the arrangement under which a payment is made does not provide for a deferred payment and the payment is made no later than the 15th day of the third month following the later of the end of the service provider's taxable year or the end of the service recipient's taxable year in which occurs the later of the time the legally binding right to the payment arises or the time such right first ceases to be subject to a substantial risk of forfeiture (subject to certain extensions for unforeseeable events). For this purpose, an arrangement provides for a deferred payment if it provides for a payment that will be made or completed after a date or an event that will or may occur later than the end of the 2½ month period described in the preceding sentence, either because of an affirmative election on the part of the service provider or service recipient or a deferral condition inherent in the terms of the contract (for example, that the amount will be paid upon the service provider's separation from service, which may occur in a future year).

Several commentators requested that additional flexibility be provided to al-

low payments to be short-term deferrals. By analogy to the rules in the proposed regulations concerning when payments of deferred compensation amounts are considered timely for purposes of the payment date rules, the commentators suggested that payments should qualify as short-term deferrals if made by the end of the year after the year in which a substantial risk of forfeiture lapses, rather than by the 15th day of the third month of that year. The final regulations do not adopt this suggestion. The short-term deferral rule is based on the historical treatment of certain payments paid within a short period following the end of a taxable year as not constituting deferred compensation. See §1.404(b)-1T, Q&A-2(b). That short period has been defined as ending on the 15th day of the third month following the end of the year, subject to certain extensions for unforeseeable events. Extending the payment date by which a short-term deferral could be paid would be inconsistent with this approach and the legislative history of section 409A (H.R. Conf. Rep. No. 108-755, at 735 (2004)), and accordingly is not adopted in the final regulations. However, the final regulations liberalize the standard under which a payment can be a short-term deferral even if it is delayed due to unforeseeable events. The proposed regulations provided generally that payment could be delayed if the payment would jeopardize the service recipient's solvency and such insolvency was unforeseeable at the time the service provider obtained the right to the payment. By contrast, the final regulations provide generally that payment may be delayed where the payment would jeopardize the ability of the service recipient to continue as a going concern.

Commentators asked how the short-term deferral rule applies to a series of payments scheduled to commence following the lapse of a substantial risk of forfeiture. The final regulations provide that the short-term deferral rule applies separately to each payment, applying the technical definition of "payment" set out in the regulations, provided that the entire payment is made during the short-term deferral period. Accordingly, where a payment has been designated as a separate payment, it may qualify as a short-term deferral (and thus not deferred compensation) even where the service provider has

a right to subsequent payments under the same arrangement. In contrast, where a payment has not been designated as a separate payment (such as, for example, a life annuity payment or a series of installment payments treated as a single payment), any initial payments in the series will not be treated as a short-term deferral even if paid within the short-term deferral period. For a discussion of the definition of payment, see §1.409A-3.

Commentators suggested that a right to a reimbursement be treated as potentially subject to the short-term deferral rule, arguing that the right to the reimbursement payment is subject to a substantial risk of forfeiture that the service provider will not incur the expense. Commentators argued that the short-term deferral rule then could apply if the reimbursement payment were made within a short period following the occurrence of the expense. Generally, the risk that a service provider will fail to incur a reimbursable expense will not qualify as a substantial risk of forfeiture, so the short-term deferral rule will not be applicable. However, the final regulations provide considerable additional flexibility with regard to structuring reimbursement arrangements to meet the requirements of section 409A. For a discussion of these provisions, see section VII.B.2 of this preamble.

2. Application to event-based payments

Some commentators asked whether any payments based on a legally binding right arising in the year of a separation from service are excluded from coverage under section 409A, if paid by the end of the relevant short-term deferral period. For example, where an employee had accrued benefits under a defined benefit supplemental executive retirement plan (SERP) during his career that was payable immediately upon a separation from service, including an amount accrued in the year of separation from service, commentators asked whether the payment of the portion of the benefits accrued in that final year is excluded from coverage under section 409A if paid by March 15 of the year following the separation from service, because the amount is paid within a short period following the year the service provider obtains a vested legally binding right to the additional benefit accrual. (This gener-

ally would be of most concern to specified employees subject to the requirement of a six-month delay in payment following a separation from service.)

The analysis that applies in this situation is similar to that applied to the general definition of deferral of compensation, discussed in section III.A of this preamble. The short-term deferral rule does not provide an exclusion from the requirements of section 409A for such current-year benefit accruals because the rule does not apply to amounts of compensation subject to a deferral election. For this purpose, an election to defer includes either an affirmative election on the part of the service provider or a deferral condition inherent in the terms of the contract. Where the parties have agreed that a payment will be made upon an event that does not necessarily coincide with the lapsing of the substantial risk of forfeiture, and could occur at a time beyond the short-term deferral period, the arrangement provides for a deferral election such that the short-term deferral rule does not apply. Accordingly, in this example, because the benefits accrued in the final year of the SERP could have been paid upon an event occurring after the short-term deferral period (if, for example, the individual had not separated from service until a later year), the payment of the benefit accrued in the final year is subject to section 409A and is not a short-term deferral, even if paid by March 15 of the year following the separation from service.

Also, for example, if a plan that is not subject to section 457(f) provides that an amount is subject to a substantial risk of forfeiture until the completion of three years of service, and is payable upon a separation of service following the three years of service, the right to the amount is not a short-term deferral even if the service provider separates from service immediately after vesting in the right, because under the plan the payment is based upon an event other than the lapsing of the substantial risk of forfeiture and such event may occur in a year subsequent to the year in which the risk of forfeiture lapses.

Conversely, where a plan specifies no payment date or payment event, or specifies only the date at which the substantial risk of forfeiture lapses, the plan may qualify for the short-term deferral rule if

the payment is made within the applicable short-term deferral period. However, such a plan generally would violate section 409A if the payment were made after the short-term deferral period.

As discussed in this preamble with respect to the general definition of deferred compensation, to implement the statutory scheme, including the applicable reporting and form requirements, taxpayers generally must be able to determine whether an arrangement provides for a deferral of compensation at the time the service provider obtains a legally binding right to the compensation. Although a plan need not specify a payment date to be a short-term deferral that is excluded from coverage under section 409A, the short-term deferral exclusion does not apply if the payment event or date is specified and will or may occur after the end of the short-term deferral period.

The preamble to the proposed regulations explained that where a plan requires that a payment be made on a date within the short-term deferral period, but the payment is made after the specified date and after the end of the short-term deferral period, the arrangement will be treated as a nonqualified deferred compensation plan, but the payment date will be treated as a specified date. Thus, under such an arrangement, if the service provider receives the payment after the specified date, but not later than the end of the year in which the specified date occurs, the payment generally will comply with section 409A. However, taxpayers should note that a provision requiring only that a payment be made on or before the end of the short-term deferral period may not qualify as a permissible specified date for this purpose, if under the facts and circumstances the payment could have been made in more than one taxable year. For a discussion of the application of the definition of a specified payment date to this type of plan, see section VII.B of this preamble.

For a discussion of when rights to compensation upon a separation from service for good reason may be treated as rights to compensation upon an involuntary termination, and the potential application of the short-term deferral exception to these arrangements, see section III.J.3 of this preamble.

D. Stock options and stock appreciation rights

1. In general

Subject to the modifications described in this preamble, the final regulations adopt the provisions of the proposed regulations excluding from coverage under section 409A statutory stock options and certain other stock rights. Generally under the regulations, nondiscounted stock options and nondiscounted stock appreciation rights issued on service recipient stock that do not include any additional deferral feature are excluded from section 409A.

2. Statutory stock options

The final regulations adopt the exclusion from coverage under section 409A for statutory stock options, including incentive stock options described in section 422 of the Code and options granted under an employee stock purchase plan described in section 423 of the Code. This exclusion applies regardless of whether the statutory stock option would be excluded if the same option were not treated as a statutory stock option. For example, an employee stock purchase plan described in section 423 offering a discounted purchase price is not a deferred compensation plan for purposes of section 409A.

Commentators requested clarification, however, of the treatment of a statutory stock option that is modified, or otherwise becomes ineligible to be treated as a statutory stock option. The final regulations adopt the rule set forth in the proposed regulations, and provide that at the time of such modification or event, the modification or other event is treated as the grant of a new option, or causes the option to be treated as having had a deferral feature from the date of grant, as applicable, for purposes of section 409A only if such modification or other event would have been so treated had the option been a nonstatutory stock option immediately before such modification or other event. For example, where an incentive stock option is modified through an extension of the option's term, the extended option will be treated as having had an additional deferral feature from the date of grant for section 409A purposes only if the same extension

of a nonstatutory stock option would have resulted in such treatment.

Commentators also requested that the exclusion from coverage under section 409A for certain stock rights issued under plans meeting the requirements of section 423 (employee stock purchase plans) be extended to employee stock purchase plans offered by foreign employers that do not meet such requirements, where the shares are made available for purchase at a discount and substantially all of the participants are nonresident aliens. The legislative history does not provide a basis for extending the exception applicable to options meeting the requirements of section 423 to grants of discounted stock options not meeting the requirements of section 423. Accordingly, this suggestion is not adopted in the final regulations.

3. *Definition of service recipient stock*

The final regulations adopt the requirement in the proposed regulations that for the exclusion for certain stock rights to apply, the stock right must relate to service recipient stock. Commentators criticized the definition of service recipient stock contained in the proposed regulations as too restrictive. Generally such criticisms centered on two different aspects of the definition of service recipient stock in the proposed regulations – the classes of stock that may qualify as service recipient stock, and the issuer or issuers whose stock may constitute service recipient stock, where the service recipient is comprised of more than one entity.

a. *Classes of stock that may qualify as service recipient stock*

Commentators requested clarification and expansion of the classes of stock of a corporation that may constitute service recipient stock. Commentators generally focused on two issues. First, with respect to stock of a particular service recipient corporation, commentators requested that the stock right be permitted to relate to any class of common stock, regardless of whether another class of common stock of that corporation was publicly traded, and regardless of whether that class of common stock had the greatest aggregate value of all classes of common stock issued by that corporate entity. Subject to the restrictions governing certain preferences as

to distributions, the final regulations generally provide that any class of common stock may be used, regardless of whether another class of common stock that could qualify as service recipient stock is publicly traded or has a higher aggregate value outstanding, and regardless of whether the class of stock is subject to transferability restrictions or buyback rights (provided such buyback rights reflect the fair market value of the stock at the time of purchase).

Second, commentators suggested narrowing the types of preferences on a class of common stock that would prohibit that class from being treated as service recipient stock. One commentator requested that the classes of stock permitted as service recipient stock include any class of stock that is widely held by non-service recipients. While it may be unlikely that a widely-held class of stock was created to facilitate an abusive avoidance of section 409A, it does not follow that service recipient stock rights issued on such stock necessarily would be consistent with the intended application of section 409A if, for example, holders of such class enjoyed preferences that would make such stock rights a suitable substitute for nonqualified deferred compensation.

To be treated as service recipient stock under the final regulations, a class of stock must qualify as common stock under section 305 of the Code. Accordingly, the final regulations provide that stock that is not common stock under section 305 is not service recipient stock for purposes of section 409A. However, the mere classification of a class of stock as common stock under section 305 is not sufficient for such stock to be treated as service recipient stock for purposes of section 409A. The Treasury Department and the IRS are concerned that classes of stock that are common stock under section 305 may provide preferences that could permit stock rights with respect to such stock to resemble traditional nonqualified deferred compensation, such that exclusion of such stock rights would permit the avoidance of section 409A.

Commentators suggested that a preference with respect to liquidation rights, without any other preferences such as a preferential right to dividends, should be permitted under the definition of service recipient stock. A holder of this class of stock would not be guaranteed any return,

but rather would simply be guaranteed preferred distribution rights upon a complete liquidation of the service recipient. The final regulations generally adopt this suggestion.

With respect to other preferential rights, commentators were unable to provide a workable standard under which permissible preferences could be distinguished from impermissible preferences. Accordingly, the final regulations do not treat any stock including such preferences as service recipient stock. However, the Treasury Department and the IRS continue to study this area, and the final regulations authorize the publication of other additional guidance, should a workable standard be developed.

b. *Entities the stock of which may qualify as service recipient stock*

Commentators also requested an expansion of the class of entities the stock of which can qualify as service recipient stock where the service recipient is comprised of multiple entities. The Treasury Department and the IRS believe that the stock right exception under section 409A was intended to cover stock rights directly reflecting the enterprise value of the entity for which the service provider is providing services. Consistent with this approach, the final regulations provide that service recipient stock may include the stock of the corporation for which the service provider was providing services at the date of grant. In addition, the final regulations provide that service recipient stock may include stock of any corporation in a chain of organizations all of which have a controlling interest in another organization, beginning with the parent organization and ending with the organization for which the service provider was providing services at the date of grant of the stock right. Similarly to the proposed regulations, the final regulations provide that the term “controlling interest” has the same meaning as provided in §1.414(c)-2(b)(2)(i), except that where that regulation requires at least an 80 percent interest, the final regulations generally require only a 50 percent interest. In addition, where the use of such stock with respect to the grant of a stock right to such service provider is based upon legitimate business criteria, the final regulations generally require

only a 20 percent interest. For purposes of determining ownership of an interest in an organization, the attribution rules of §1.414(c)-4 apply, and the exclusion rules of §1.414(c)-3 also apply. For example, under the final regulations, with respect to an employee of a subsidiary corporation, the common stock of the ultimate parent corporation, or of a subsidiary corporation anywhere in the chain of corporate ownership between the subsidiary that employed the employee and the ultimate parent corporation (a higher tier subsidiary), could qualify as service recipient stock for purposes of determining whether a stock right issued to such employee with respect to such stock was excluded from coverage under section 409A, provided that the 50 percent or 20 percent ownership standard, as applicable, was satisfied by each corporation in the chain.

The proposed regulations contained many requirements for using an ownership level of less than 50 percent. Commentators requested several simplifications of these requirements. In response, the final regulations no longer require a formal election by any corporation. Rather, each individual grant of a stock right is analyzed to determine whether the stock qualifies as service recipient stock with respect to a service provider at the time the stock right is granted. If a corporation owns at least 50 percent of the stock of one corporation and owns less than 50 percent of the stock of another corporation, and it intends to treat its stock as service recipient stock with respect to employees of both corporations, there is no requirement that a legitimate business criteria exist with respect to the issuance of stock rights on the parent corporation stock to service providers of the first such corporation. The legitimate business criteria standard applies only to stock rights issued to service providers of subsidiaries that are not majority-owned, because the test of legitimate business criteria relates to the actual issuance of a stock right to a particular service provider. Accordingly, a subsidiary may have more than one shareholder corporation the stock of which qualifies as service recipient stock with respect to a subsidiary employee such as, for example, where three entities each own a one-third interest in the subsidiary. However, with respect to each grant of a stock right on stock of a particular non-majority share-

holder corporation to a service provider of a particular subsidiary, there must exist legitimate business criteria for issuing such a stock right. Even if legitimate business criteria exist with respect to the issuance of a stock right on stock of a particular shareholder corporation to a particular service provider, legitimate business criteria may or may not exist with respect to the issuance of a stock right to the same service provider on stock of another shareholder corporation.

The legitimate business criteria requirement is a facts and circumstances test, focusing generally on whether there is sufficient nexus between a particular service provider and the entity, the stock of which underlies the stock right granted to the service provider, for the grant to serve a legitimate non-tax business purpose. As provided in the preamble to the proposed regulations, if a corporation issued a stock right on its stock to a current employee of a joint venture in which the corporation was a venturer, and the employee was a former employee of the corporate venturer, generally the issuance would be based on legitimate business criteria. Similarly, if the corporate venturer issued such a right to an employee of the joint venture who it reasonably expected would become an employee of the corporate venturer in the future, generally the legitimate business criteria requirement would be met. By contrast, where an employee has no real nexus with a corporate venturer, such as generally happens when the corporate venturer is a passive investor in the service recipient, the use of the investor corporation stock as the stock underlying a stock right grant to that employee generally would not be based upon legitimate business criteria. Similarly, where a corporation holds only a minority interest in an entity that in turn holds a minority interest in the entity for which the employee performs services, such that the corporation holds only an insubstantial indirect interest in the entity receiving the services, legitimate business criteria generally would not exist for issuing a stock right on the corporation's stock to the employee.

The Treasury Department and the IRS remain concerned that the manipulation of the structure of a related group of corporations may be used to allow stock options or stock appreciation rights to mimic the characteristics of nonqualified deferred

compensation, by compensating holders based on predictable amounts and investment returns unrelated to the enterprise value of an operating entity. Accordingly, the exception contained in the proposed regulations under which the stock of a corporation serving as investment vehicle is not considered service recipient stock has been retained. In addition, an anti-abuse rule has been added to address corporate structures, transactions, or stock right grants, a principal purpose of which is the avoidance of the application of section 409A to an arrangement otherwise providing deferred compensation. These corporate structures, transactions, and stock right grants generally will occur where the structure, transaction, or grant is intended to provide enhanced security for the value of the stock right as a means of providing deferred compensation, rather than as compensation related to an increase in the true enterprise value of the service recipient. The regulations provide that if an entity becomes a member of a group of corporations or other entities treated as a single service recipient, and the primary source of income or value of such entity arises from the provision of management services to other members of the service recipient group, if any stock rights are issued with respect to such entity it is presumed that such structure was established for purposes of avoiding the application of section 409A.

c. Equity interests in certain non-corporate entities

The final regulations permit certain equity interests in a non-stock mutual company to be treated analogously to equity interests in a corporation. Commentators requested that the definition of service recipient stock be expanded to cover interests in cooperatives and interests in the value of an Indian tribal enterprise. The regulations do not include such interests in the definition of service recipient stock, but provide the IRS authority to provide guidance expanding the definition of service recipient stock. For a discussion of the application of the exclusion for certain stock rights to rights issued on equity interests in entities taxed as partnerships, see section III.G of this preamble.

4. Valuation

a. In general

The final regulations provide that for the exclusion for stock rights to apply, the stock right must specify an exercise price of the stock right that may never be less than the fair market value of the underlying stock on the date the stock right is granted. For purposes of this discussion and the final regulations, the exercise price of a stock appreciation right refers to the base stock value from which the appreciation is measured for purposes of determining the compensation payable under the stock appreciation right (for example, a stock appreciation right providing for a payment of the excess of the fair market value of 100 shares over \$100 would have a \$1 per share exercise price).

Several commentators expressed concerns regarding the determination of the fair market value of the underlying stock. Some commentators requested that the valuation rules applicable to incentive stock options be applied for purposes of the exclusion from section 409A. Under those rules, if the stock option would otherwise fail to be an incentive stock option solely because the exercise price was less than the fair market value of the underlying stock as of the date of grant, generally the option is treated as an incentive stock option if the issuer attempted in good faith to set the exercise price at fair market value. See section 422(c)(1). The Treasury Department and the IRS believe that this is not the appropriate standard for determining whether stock rights are subject to section 409A. Incentive stock options are subject to strict limitations on the amount of such options that may be granted to a particular employee. See section 422(d). In contrast, there are no such limits applicable to nonstatutory stock options, and grants of nonstatutory stock options often far exceed the limitation applicable to incentive stock options. In addition, section 422(c)(1) explicitly provides for the good faith standard with respect to incentive stock options, while no such provisions exist within section 409A or its legislative history.

Commentators requested clarification of the consistency standard with respect to the use of a valuation method. Specifically, commentators asked whether one

valuation method could be used for purposes of establishing the exercise price while another method could be used for purposes of determining the fair market value of the stock at the time of the payment (for example, to determine the amount of payment in the case of a stock appreciation right or a stock option where the stock is subject to repurchase by the service recipient). The final regulations clarify that consistency is not required, provided that each valuation method used otherwise meets the requirements of the final regulations. Accordingly, a service recipient may use one valuation method for purposes of establishing an exercise price, but another valuation method for purposes of establishing the payment amount (in the case of a stock appreciation right) or the buyback amount (in the case of a stock option where the underlying stock is subject to a buyback arrangement). However, once an exercise price has been established, the exercise price may not be changed through the retroactive use of another valuation method. In addition, where after the date of grant, but before the date of exercise, of the stock right, the service recipient stock to which the stock right relates becomes readily tradable on an established securities market, the service recipient must use a valuation method for stock readily tradable on an established securities market for purposes of determining the payment amount (in the case of a stock appreciation right) or the buyback amount (in the case of a stock option where the underlying stock is subject to a buyback arrangement).

b. Valuation — stock readily tradable on an established securities market

The final regulations adopt the rules under the proposed regulations governing valuation of stock readily tradable on an established securities market, generally requiring that the valuation of such stock be based upon the contemporaneous prices established in the securities market, subject to the modifications discussed in this preamble. Some commentators requested additional guidance with respect to when a stock will be treated as readily tradable. The final regulations adopt the same standard as that set forth in §1.280G-1, Q&A-6(e), that stock is treated as readily

tradable if it is regularly quoted by brokers or dealers making a market in such stock.

With respect to the rules governing the valuation of stock that is readily tradable on an established securities market, commentators generally focused on the provision of the proposed regulations permitting the use of an average selling price during a specified period that is within 30 days before or 30 days after the date of grant. Specifically, comments concentrated on the requirement that the commitment to grant the stock right with an exercise price set using such an average selling price be irrevocable before the beginning of the specified period. Commentators questioned both the purpose of the requirement of the commitment to the valuation method, as well as the actions required to satisfy the rule if averaging were being used.

The rule was intended to prohibit the use of an average price, set on a look-back basis, to ensure a discounted exercise price. For example, if a corporation decided to grant a stock option on July 1, and it could set the exercise price using an average selling price for any period falling within the prior 30 days without having had a prior commitment to a specific averaging period, the corporation could simply look for the lowest price that occurred during the prior June. Furthermore, if the corporation were not committed to grant the stock option on July 1, the corporation could wait until its stock price began to rise and then grant an option using the selling price on a given day during the previous 30 days to provide a particular discount. Accordingly, the final regulations require that the commitment to grant the stock right with an exercise price set using such an average selling price be irrevocable before the beginning of the specified period. To satisfy this requirement, the service recipient must designate the recipient of the stock option, the number of shares the stock option will permit the holder of the stock option to purchase, and the method for determining the exercise price including the period over which the averaging will occur, before the beginning of the specified averaging period.

One commentator stated that the requirement of an irrevocable commitment to the averaging period could not be met under French law, because French law requires that the stock option exercise price

be set based on the average trading price over the preceding 20 days and the commitment to the grant before the beginning of the period may be viewed as violating that requirement. The final regulations provide that where applicable foreign law requires that the compensatory stock right granted by the issuer must be priced based upon a specific price averaging method and period, a stock right granted in accordance with such applicable foreign law will be treated as meeting the requirement, provided that the averaging period may not exceed 30 days.

c. Valuation – stock not readily tradable on an established securities market

i. In general

The final regulations adopt the provisions in the proposed regulations relating to the valuation of stock not readily tradable on an established securities market, subject to the modifications discussed in this section III.C.4.c. Accordingly, a valuation of stock based upon a reasonable application of a reasonable valuation method is treated as reflecting the fair market value of the stock. To meet this standard, it is not necessary that a taxpayer demonstrate that the value was determined by an independent appraiser. Where the taxpayer can otherwise demonstrate that the valuation was determined by the reasonable application of a reasonable valuation method, the standard will be met.

One commentator requested that the factors to be considered in determining the fair market value of the stock should be modified to include consideration of any recent equity sales made by the corporation in arm's-length transactions. The final regulations adopt this suggestion.

The final regulations continue to require that in the case of a stock right issued with respect to stock that was not publicly traded at the time the right was issued, but becomes publicly traded before the right is exercised, the stock value for purposes of calculating the payment amount (in the case of a stock appreciation right) or the buyback amount (in the case of a stock option where the underlying stock is subject to a buyback agreement) must be based upon the rules governing stock that is publicly traded. This does not mean that the initial exercise price de-

termined under the rules governing stock that is not publicly traded must be reset. Rather, this means only that the value at the time of exercise used to determine the payment amount or the buyback amount must be determined under the rules governing stock that is publicly traded. For example, if a service provider holds an excluded stock appreciation right with an exercise price of \$1 that was fixed based on a valuation of the closely-held corporate stock at the time of grant, and before exercise the stock becomes readily tradable on an established securities market, the amount payable upon exercise must be the excess of the value of the stock based on its trading price over the \$1 exercise price.

ii. Safe harbor presumptions

The final regulations adopt a presumption in specified circumstances that, for purposes of section 409A, a valuation of stock reflects the fair market value of the stock, rebuttable only by a showing that the valuation is grossly unreasonable. The presumption applies where the valuation is based upon an independent appraisal, a generally applicable repurchase formula (applicable for both compensatory and noncompensatory purposes) that would be treated as fair market value under section 83, or, in the case of illiquid stock of a start-up corporation, a valuation by a qualified individual or individuals applied at a time that the corporation did not otherwise anticipate a change in control event or public offering of the stock.

Many of the comments with respect to these presumptions related to the presumption applicable to illiquid stock of start-up corporations. As set forth in the proposed regulations, the start-up corporation presumption would not apply if the service recipient or service provider could reasonably anticipate, as of the time the valuation is applied, that the service recipient would undergo a change in control event or make a public offering of securities within the 12 months following the event to which the valuation is applied. Commentators suggested that a 12-month period is too long, because changes occur so rapidly in the business world that it often is difficult or impossible to predict so far in advance whether such an event will occur. Commentators suggested that the service provider should retain the benefit of the

presumption unless the issuing corporation entered into a definitive agreement or filed its registration statement with the Securities and Exchange Commission within a period of 15 or 30 days after issuing the stock right.

The Treasury Department and the IRS believe that a 15-day or a 30-day period is too short. Although there is always a risk that a public offering will fail or that a corporate transaction will not occur, the Treasury Department and the IRS also believe that a person should reasonably be able to anticipate whether such a transaction will occur during a reasonable period before the transaction.

Accordingly, the final regulations provide that the start-up corporation presumption will not apply if at the time the valuation is made, the service recipient or service provider may reasonably anticipate that the service recipient will undergo a change in control event in the next 90 days or an initial public offering within the next 180 days. As under the proposed regulations, the rule in the final regulations is concerned with what the parties may reasonably anticipate at the time the stock right is issued.

Other comments requested examples of persons with sufficient knowledge, experience, and skill in valuing illiquid stock of a start-up corporation. Because knowledge, skill and training may be obtained in different ways, the final regulations do not provide specific examples. However, the regulations clarify that the standard to be applied is whether a reasonable individual, upon being apprised of such person's relevant knowledge, experience, education and training, would reasonably rely on the advice of such person with respect to valuation in deciding whether to accept an offer to purchase or sell the stock being valued. The final regulations also clarify that significant experience generally means at least five years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry in which the service recipient operates.

With respect to the presumption based upon a generally applicable buyback formula, some commentators requested that the presumption apply where the formula is applicable to all compensatory stock

transactions, but not also applicable to all noncompensatory stock transactions. The final regulations do not adopt this suggestion. However, the final regulations clarify that to meet the requirements of the presumption, the buyback formula is required to be applicable to compensatory and non-compensatory transactions with the issuer or a person owning 10 percent or more of the stock of the issuer, but is not required to be applicable to transactions with other persons or transactions that are part of an arm's length transaction constituting the sale of all or substantially all of the stock of the issuer to an unrelated purchaser.

5. *Modification of a stock right*

The final regulations continue to apply certain rules addressing modifications, extensions and renewals of stock rights. Although these rules in many respects resemble the rules applicable to statutory stock options, the rules are not intended to incorporate the rules applicable to statutory stock options except where explicitly provided.

The final regulations generally retain the rules in the proposed regulations that generally treat extensions of the exercise period of a stock right as an additional deferral feature as of the date of grant of the right, with an exception for certain limited extensions following a separation from service. Commentators characterized these rules as unnecessarily restrictive. Specifically, commentators argued that the extension of a stock option upon the occurrence of a separation from service (often in connection with a program of layoffs) or a corporate transaction is a common practice, and that often these extensions cover periods longer than the limited period provided in the proposed regulations. In addition, commentators argued that the same substantive results could be obtained by specifying a longer term for the stock right and providing the service recipient the discretion to shorten the term, rather than providing discretion to extend a shorter term, and that the former approach would be permissible under the proposed regulations. In response, the final regulations provide that the extension of an option exercise period generally is not treated as an additional deferral feature or a modification of the stock option for section 409A purposes if the exercise period is not

extended beyond the earlier of the original maximum term of the option or 10 years from the original date of grant of the stock right.

Many commentators also requested that the extension of the exercise period of a stock right not be treated as an additional deferral feature for purposes of section 409A, where at the time of the extension the fair market value of the underlying stock does not exceed the exercise price (an "underwater" option). Because the issuance of an otherwise identical option with an exercise period ending after the end of the exercise period of the underwater option would be excluded from coverage under section 409A, the final regulations provide that such an extension does not constitute an additional deferral feature.

The final regulations adopt the provisions in the proposed regulations regarding substitution or assumption of stock rights due to a corporate transaction, which are generally in accordance with the corresponding provisions governing incentive stock options. The final regulations clarify that the applicable corporate transactions for this purpose include only those transactions described in §1.424-1(a)(3). One commentator requested that the provision permitting substitutions of stock options be modified to reflect that a holder of a nonstatutory stock option is not required to be employed by the successor entity. The final regulations adopt this suggestion, so that a substituted nonstatutory stock option may be treated as a continuation of the initial option even where the holder of the option is not employed or otherwise providing services to the successor entity, provided the substitution otherwise meets the rules provided in the regulations.

6. *Other stock right issues*

The final regulations adopt certain definitions from the regulations governing statutory stock options, modified as appropriate for purposes of applying the rules under section 409A. These include the time and date of grant of an option (§1.421-1(c)), and the definitions of option (§1.421-1(a)), stock (§1.421-1(d)), exercise price (§1.424-1(e)), exercise (§1.421-1(f)), and transfer (§1.421-1(g)). These definitions apply by analogy to stock appreciation rights.

The final regulations adopt the rule that a right to a payment of accumulated dividend equivalents at the time of the exercise of a stock right generally will be treated as a reduction in the exercise price of the stock right, causing the stock right to be deferred compensation subject to the requirements of section 409A. The final regulations provide that an arrangement to accumulate and pay dividend equivalents the payment of which is not contingent upon the exercise of a stock right may be treated as a separate arrangement for purposes of section 409A. Such an arrangement generally will be required to comply with section 409A (unless it independently qualifies for an exception from coverage under section 409A), but will not affect whether the related stock right qualifies for the exclusion from coverage under section 409A. The right to the dividend equivalents may be set forth within the stock right plan or the individual stock right grant, or in a separate document, as long as the payment of the dividend equivalents is not contingent upon the exercise of the stock right.

Commentators also asked whether the exclusion of stock rights from coverage under section 409A would apply to tandem rights, meaning a stock right that combines a stock option right and a stock appreciation right, exercisable on an alternative basis. Similarly, commentators asked whether the substitution of a stock option for a stock appreciation right, or *vice versa*, where all the terms except the mode of payment upon exercise are similar, would be treated as a modification of a stock right. The application of section 409A generally is not affected by the medium of a taxable payment (for example, cash or stock). Accordingly, whether a stock right is expressed as a tandem arrangement under which the exercise of one right terminates the other right, or there is a substitution of a stock appreciation right for a stock option identical in all respects except for the medium of payment, generally does not impact whether the arrangement is excluded from coverage under section 409A.

Commentators requested further clarification of the application of section 409A to stock option gain deferrals. The ability to defer gain upon the exercise or exchange (including a purported forfeiture) of a stock right is incompatible with the exclusion of certain stock rights from the requirements of section 409A because such

exclusion is predicated on the option not having any additional deferral feature. Accordingly, if an arrangement provides for a potential to defer the payment of cash or property upon the exercise or exchange of a stock right beyond the year the right is exercised or beyond the original term of the stock right, the arrangement provides for a deferral feature and must comply with the requirements of section 409A from the time the legally binding right granted by the award arises.

Because a stock option with a deferral feature is subject to section 409A regardless of whether the deferral feature is actually utilized, an option that includes a provision permitting deferral of option gain generally will not satisfy the time and form of payment rules under section 409A if the service provider can exercise the option in more than one taxable year. If a deferral feature is added to a preexisting option, the option will be treated as having included a deferral feature as of the original date of grant, generally resulting in a violation of section 409A.

However, the final regulations provide that a stock right will not be treated as having a deferral feature where the service recipient delays a payment because the making of the payment would violate applicable Federal, state, local, or foreign law or jeopardize the ability of the service recipient to continue as a going concern. Although these provisions permit the delay for purposes of section 409A, no inference should be drawn as to the Federal tax consequences of such a delay under any other section of the Code or Federal tax doctrine such as section 83, section 451, the constructive receipt doctrine, or the economic benefit doctrine.

Commentators requested that the definition of service recipient stock be expanded to include the stock of a corporation for which a service recipient provides substantial services, at least with respect to a service provider of the service recipient that is providing services to the corporation. The legislative history does not support such a broad interpretation of service recipient stock, and the final regulations do not adopt this suggestion.

E. Restricted property

The final regulations provide, as did the proposed regulations, that a grant of re-

stricted property generally will not constitute a deferral of compensation for purposes of section 409A. Commentators requested that the regulations clarify that a vested right to receive nonvested property in a future year does not constitute deferred compensation. Commentators argued that a right to receive nonvested property is not truly vested. For example, commentators argued that a right to receive restricted stock that will be subject to a substantial risk of forfeiture until the service provider completes three years of future services cannot be a vested right. The final regulations adopt this suggestion, so long as the risk of forfeiture to which the stock is subject constitutes a substantial risk of forfeiture for purposes of section 409A.

Commentators specifically requested clarification of the circumstances under which a service provider may elect to be paid a bonus or other payment in the form of restricted stock, rather than cash. Generally an election between compensation alternatives, none of which provides for a deferral of compensation within the meaning of section 409A, will not cause the election to be subject to the section 409A timing restrictions. Thus, a choice between an award of restricted stock or stock options that are not subject to section 409A will not be governed by the section 409A election timing rules. However, where any of the alternatives involves a deferral of compensation subject to section 409A, the election must comply with the provisions of section 409A. In addition, no inference should be drawn as to the Federal tax consequences of such an election provision under any other section of the Code or Federal tax doctrine such as section 83, section 451, the constructive receipt doctrine, or the economic benefit doctrine.

F. Section 402(b) trusts

The final regulations continue to except from coverage under section 409A transfers of a beneficial interest in a trust, or a transfer to or from a trust, to the extent such a transfer is subject to section 402(b). The final regulations further clarify that a right to compensation required to be included in income under section 402(b)(4)(A) (alternative taxation of highly compensated employees of a section 402(b) trust that fails to meet the requirements of section

401(a)(26) or section 410(b)) also is not a deferral of compensation. However, a right to receive a benefit formulated as a right to a future contribution to a section 402(b) trust is similar to a right to receive property in a future taxable year, and generally would constitute deferred compensation.

G. Arrangements between partnerships and partners

The proposed regulations did not address the application of section 409A to arrangements between partnerships and partners, and these final regulations also do not address such arrangements. The statute and the legislative history of section 409A do not specifically address arrangements between partnerships and partners providing services to a partnership and do not explicitly exclude such arrangements from the application of section 409A. Commentators raised a number of issues, relating both to the scope of the arrangements subject to section 409A and the coordination of the provisions of subchapter K and section 409A with respect to those arrangements that are subject to section 409A. The Treasury Department and the IRS are continuing to analyze the issues raised in this area. Notice 2005-1, Q&A-7 provides interim guidance regarding the application of section 409A to arrangements between partnerships and partners. Until further guidance is issued, taxpayers may continue to rely on Notice 2005-1, Q&A-7 and sections II.E and VI.E of the preamble to the proposed regulations.

Notice 2005-1, Q&A-7 provided that until further guidance is issued for purposes of section 409A, taxpayers may treat the issuance of a partnership interest (including a profits interest) or an option to purchase a partnership interest, granted in connection with the performance of services under the same principles that govern the issuance of stock. For this purpose, taxpayers may apply the principles applicable to stock options or stock appreciation rights under these final regulations, as effective and applicable, to equivalent rights with respect to partnership interests.

Taxpayers also may continue to rely upon the explanation in the preamble to the proposed regulations regarding the application of section 409A to guaranteed payments for services described in sec-

tion 707(c). As stated in that preamble, until further guidance is issued, section 409A will apply to guaranteed payments described in section 707(c) (and rights to receive such guaranteed payments in the future), only in cases where the guaranteed payment is for services and the partner providing services does not include the payment in income by the 15th day of the third month following the end of the taxable year of the partner in which the partner obtained a legally binding right to the guaranteed payment or, if later, the taxable year in which the right to the guaranteed payment is first no longer subject to a substantial risk of forfeiture.

Commentators raised issues concerning the application of the provision in Notice 2005-1, Q&A-7 stating that until further guidance is issued, taxpayers may treat arrangements providing for payments subject to section 736 (payments to a retiring partner or a deceased partner's successor in interest) as not being subject to section 409A, except that an arrangement providing for payments that qualify as payments to a partner under section 1402(a)(10) is subject to section 409A. Section 1402(a)(10) provides for an exception from the Self-Employment Contributions Act (SECA) tax for payments to a retired partner, provided that certain conditions are met. Specifically, the payments must be made pursuant to a written plan of the partnership, must be on account of the partner's retirement and must continue at least until the partner's death. In addition, to qualify for the exception, the partner must not have rendered services during the partnership's taxable year ending within or with the partner's taxable year in which the amounts were received, as of the close of the partnership's taxable year no obligation must exist from the other partners to such retired partner except with respect to retirement payments under such plan, and before the end of the partnership's taxable year such retired partner's share, if any, of the capital of the partnership must have been paid to him in full.

Commentators questioned the appropriateness of the inclusion of such arrangements under section 409A, because neither the statute nor the legislative history refers to section 1402(a)(10). However, the Treasury Department and the IRS believe it is appropriate for such arrangements to be subject to section 409A be-

cause such arrangements are purposefully created to provide deferred compensation, and do not raise issues regarding the coordination of the provisions of section 409A with the provisions of section 736, specifically the rules governing the classification of payments to a retired partner under section 736(a) (payments considered as distributive share or guaranteed payments) and section 736(b) (payments for interest in partnership).

However, further clarification and relief is provided concerning the application of the deferral election timing rules to these payments. Until further guidance is issued, for purposes of section 409A, taxpayers may treat the legally binding right to the payments excludible from SECA tax under section 1402(a)(10) as arising on the last day of the partner's taxable year before the partner's first taxable year in which such payments are excludible from SECA tax under section 1402(a)(10), and the services for which the payments are compensation as performed in the partner's first taxable year in which such payments are excludible from SECA tax under section 1402(a)(10). Accordingly, for purposes of section 409A, the time and form of payment of such amounts generally may be established, including through an election to defer by the partner, on or before the final day of the partner's taxable year immediately preceding the partner's first taxable year in which such payments are excludible from SECA tax under section 1402(a)(10). However, this interim relief does not apply a second time where an amount paid under an arrangement in one year has been excluded from SECA tax under section 1402(a)(10), and an amount paid in a subsequent year has not been excluded from SECA tax under section 1402(a)(10) because, for example, the partner performed services in that subsequent year.

H. Foreign plans

1. Plans covered by an applicable treaty

The proposed regulations provided an exclusion from the definition of a non-qualified deferred compensation plan for any scheme, trust, or arrangement maintained with respect to an individual where contributions made by or on behalf of such individual to such scheme, trust or

arrangement are excludable for Federal income tax purposes under an applicable income tax treaty. The final regulations retain that exclusion and clarify that the exclusion applies to the extent contributions made by or on behalf of such individual to such scheme, trust, arrangement or plan, or credited allocations, accrued benefits, or earnings or other amounts constituting income, of such individual under such scheme, trust, arrangement or plan, are excludable by such individual for Federal income tax purposes pursuant to any bilateral income tax convention to which the United States is a party.

2. Exclusion for benefits earned under a broad-based foreign retirement plan

The proposed regulations contained an exclusion from coverage under section 409A for amounts deferred under a broad-based foreign retirement plan, subject to certain conditions, including that the service provider not be eligible to participate in a qualified employer plan, and that if the person is a U.S. citizen or lawful permanent resident, the exception only applies to nonelective deferrals of foreign earned income (as defined in section 911(b)(1)) that do not exceed the limits under section 415(b) and (c) that would be applicable if the plan were a qualified plan. Deferrals by participants that are nonresident aliens are not subject to the limitation based on section 415. The final regulations adopt this provision, subject to certain modifications.

Many of the commentators requested expansion of the exclusion for broad-based foreign retirement plans. One commentator requested that the exclusion apply to U.S. citizens working in the United States for a foreign employer. The Treasury Department and the IRS do not believe such an exception is justified. However, the exception for U.S. citizens or lawful permanent residents has been expanded to cover nonelective deferrals of foreign earned income as defined in section 911(b)(1) without regard to section 911(b)(1)(B)(iv) and without regard to the requirement that the income be attributable to services performed during the period described in section 911(d)(1)(A) or (B). Accordingly, the exception may now cover certain participation by a U.S. citizen or lawful permanent resident who

works overseas during only part of a year, and therefore is not a *bona fide* resident of a foreign country for an uninterrupted period that includes an entire taxable year, or is not present in the foreign country at least 330 full days during a period of 12 consecutive months.

The regulations have also been modified to address nonqualified deferred compensation plans covering *bona fide* residents of a U.S. possession. Under the regulations a *bona fide* resident of a possession who participates in a broad-based foreign retirement plan is not subject to section 409A with respect to participation in such plan. In addition, a plan substantially all of the participants in which are *bona fide* residents of a possession is eligible to be treated as a broad-based foreign retirement plan, so that U.S. citizens and resident aliens (other than *bona fide* residents of a possession) who participate in such a plan may be eligible for the more limited exclusion for participation in a broad-based foreign retirement plan.

Another commentator requested that the exclusion apply to a plan that otherwise meets the requirements for the exclusion, regardless of whether the plan is sponsored by a foreign or U.S. employer. This suggestion has been adopted in the final regulations.

Other commentators requested further clarification and revision of certain of the requirements to qualify for the exclusion. One commentator requested a safe harbor treating any plan granted favorable tax treatment under the laws of a foreign jurisdiction as qualifying for the exclusion. The Treasury Department and the IRS believe this standard is both too broad and not administrable, and this suggestion has not been adopted in the final regulations.

Another commentator requested that the regulations provide a safe harbor percentage for determining whether substantially all of a foreign plan's participants are nonresident aliens. The final regulations do not adopt such a provision. However, the final regulations clarify that in determining whether substantially all of a foreign plan's participants are nonresident aliens or *bona fide* residents of a possession, only active participants are considered. For this purpose, active participants include individuals who, under the terms of the plan and without further amendment or action by the plan sponsor,

are eligible to make or receive contributions or accrue benefits under the plan (even if the individual has elected not to participate in the plan).

A similar standard applies to the requirement that the individual not be eligible to participate in a qualified employer plan. The final regulations provide that a service provider will be treated as eligible to participate in a qualified employer plan if, under the plan's terms and without further amendment or action by the plan sponsor, the service provider is eligible to make or receive contributions or accrue benefits under the plan (even if the service provider has elected not to participate in the plan).

The final regulations also clarify that the exclusion for United States citizens and lawful permanent residents applies to nonelective deferrals even if elective deferrals are permitted under the same plan, provided that the amounts deferred through nonelective deferrals and earnings on such amounts are distinguishable from amounts deferred through elective deferrals and earnings on such amounts, such as through the use of separate accounts.

3. Tax equalization payments

The proposed regulations excluded from coverage under section 409A certain arrangements, referred to as tax equalization arrangements, that provide for payments intended to compensate the service provider for the excess of taxes actually imposed by a foreign jurisdiction on the compensation paid over the taxes that would be imposed if the compensation were subject solely to United States Federal income tax, subject to certain requirements. The final regulations adopt these provisions, subject to modifications. Based upon the comments received, the final regulations generally expand the exclusion in two respects. First, the final regulations extend the tax equalization payments exception to cover reimbursements of U.S. taxes that exceed foreign taxes. Second, the final regulations provide that the payment must be made by the end of the second taxable year of the service provider following the latest of the deadline for filing a U.S. Federal tax return or the deadline for filing foreign tax returns (or if a foreign return is not required to be filed, the due date for foreign tax payments) reflecting the compensation

for which the tax equalization payment is provided.

Commentators also asked how such reimbursement agreements could address the potential for an audit or other tax controversy, both in the U.S. and abroad. The same issue arises with respect to tax gross-up payments in general. For a discussion of the treatment of the right to such payments, see section VII.B.4 of this preamble.

4. Certain Limited Deferrals by Nonresident Aliens

The proposed regulations provided an exception for amounts deferred by a nonresident alien under a foreign plan maintained by a foreign service recipient, to the extent the amounts deferred during the year did not exceed \$10,000. The final regulations adopt this provision, subject to the modifications described in this preamble. In response to comments, the final regulations clarify that the exception applies to amounts deferred in that taxable year up to the specified limit, regardless of whether additional amounts are deferred. In making this modification, the exclusion provision has been moved from the section providing a definition of nonqualified deferred compensation plan (§1.409A-1(a)) to the section providing a definition of an amount deferred (§1.409A-1(b)). In addition, the final regulations clarify that this exception applies to earnings on amounts deferred that were subject to the exception, provided that the taxpayer can identify both the deferred amounts excepted and the applicable earnings. Finally, in response to comments requesting that the limit be increased and indexed, the final regulations increase the limit for the small deferral exception to the limit provided for elective deferrals under section 402(g).

The small deferral exception is intended to provide relief to service providers that are not U.S. citizens or lawful permanent residents, are participating in a foreign plan, and perform services in the U.S. for which they are compensated. In such cases, the nonresident alien may inadvertently defer a relatively small amount of compensation that would otherwise be subject to U.S. Federal income tax. This may occur where the service provider defers the compensation that the service provider would otherwise have been paid

for a brief period of service in the United States, or where the service provider receives service or compensation credit for a brief period of service in the United States under a benefit formula of a nonqualified deferred compensation plan.

Some commentators requested that the exemption be extended to cover all amounts deferred by nonresident aliens under foreign plans to the extent the nonresident alien provides only temporary services in the U.S. Where the compensation earned by such a nonresident alien would be subject to U.S. income tax if paid when earned, the Treasury Department and the IRS do not believe that such a broad exception is warranted.

5. Other Foreign Plans

The final regulations adopt the exclusion in the proposed regulations for deferrals of amounts that would be excluded as foreign earned income under section 911 if the amounts had been paid out when earned. The final regulations clarify that the amount is limited to an amount equal to or less than the difference between the maximum section 911 exclusion for the year and the amount actually excluded for the year. Commentators requested that the exception for the deferral of amounts that would be excluded under section 911 be relaxed, so that U.S. expatriates who return for periods longer than 30 days or who earn compensation for services performed in the U.S. that is not excluded as foreign earned income, may also take advantage of the exception. This exception was not intended to address such plans. Rather, the provision was intended to provide relief from the section 409A requirements for U.S. expatriates who intend to work full-time outside the U.S. for compensation that is less than the exclusion amount under section 911, because it would severely disadvantage such workers to expect them to request that their potential foreign employers modify standard plans to accommodate them, or to expect such workers to otherwise be able to determine how to avoid or comply with section 409A.

Commentators pointed out, however, that earnings on deferred amounts, including increases in amounts deferred under a nonaccount balance plan solely due to the passage of time, may not be treated as earned income under section 911 and

argued that, nonetheless, such amounts should not lower the amount otherwise available to be deferred under the exception. The final regulations generally provide that rights to earnings credited on amounts that qualify for this exception are also excepted from coverage under section 409A, provided that the earnings satisfy the definition of earnings in §1.409A-1(o).

I. Indemnification arrangements

The final regulations generally provide that the right to the payment of contingent amounts pursuant to a service recipient's indemnification for expenses incurred as a result of a legal claim for damages related to the service provider's performance as a service provider, to the extent permissible under applicable law, will not be treated as the right to deferred compensation. Similarly, a right to liability insurance coverage providing for such payments in the event of such a suit also will not be treated as providing for a deferral of compensation.

J. Separation pay plans

1. In general

The final regulations generally adopt the provisions addressing separation pay plans set forth in the proposed regulations, subject to certain modifications. The final regulations clarify that separation pay refers only to compensation to which the service provider's right is conditioned upon a separation from service (including a separation from service due to death or disability) and not to compensation the service provider could receive without separating from service (such as an amount also payable upon a change in control, as a result of an unforeseeable emergency, or on a date certain). For example, the right to a gross-up payment for taxes payable due to the application of section 280G will constitute separation pay if a separation from service is required to obtain the payment. The final regulations also clarify that a separation pay plan for purposes of section 409A, including for purposes of the plan aggregation rules, refers only to plans providing for payments of amounts of deferred compensation (disregarding the exceptions from the definition of deferred compensation for certain types of separation pay) where one of the conditions to the right to the

payment is a separation from service. A right to a payment upon a separation from service that is not deferred compensation does not become subject to section 409A under the plan aggregation rule. For example, the accelerated vesting due to a separation from service of stock options excluded from coverage under section 409A would not constitute a separation pay plan or otherwise become subject to section 409A under the plan aggregation rules.

The final regulations generally retain and supplement the various exceptions from the definition of deferred compensation for certain types of separation pay, providing exceptions for (1) certain *bona fide* collectively bargained arrangements, (2) certain arrangements providing separation pay due solely to an involuntary separation from service or participation in a window program in limited amounts and for a limited period of time, (3) certain foreign separation pay arrangements, (4) certain reimbursement arrangements providing for expense reimbursements or in-kind benefits for a limited period of time following a separation from service, and (5) certain rights to limited amounts of separation pay. These exceptions from coverage under section 409A for specified separation pay plans may be used in combination. For example, the rights of an employee to the maximum amount available under the exception for separation payments made solely due to involuntary separation from service or participation in a window program, to reimbursements for reasonable moving expenses and outplacement expenses that meet the requirement for exclusion from coverage under section 409A, and to rights to payments that do not exceed the limit on elective deferrals under section 402(g) and accordingly qualify for the limited payment exception, may all be excluded from coverage under section 409A due to application of the various exceptions.

The final regulations continue to provide that any amount, or entitlement to any amount, that acts as a substitute for, or replacement of, amounts deferred under a separate nonqualified deferred compensation plan constitutes a payment of deferred compensation or deferral of compensation under the separate nonqualified deferred compensation plan. Commentators asked how this would apply where the

service provider would otherwise forfeit a payment upon separation from service but a payment is made anyway, in whole or in part.

The regulations provide that if a separation from service is voluntary, it is presumed that the payment results from an acceleration of vesting followed by a payment of the deferred compensation that is subject to section 409A. Accordingly, any change in the payment schedule to accelerate or defer the payments would be subject to the rules of section 409A. The presumption that a right to a payment is not a new right, but is instead a right substituted for an existing nonvested right, may be rebutted by demonstrating that the service provider's right to the payment after the separation from service would have existed regardless of the forfeiture of the nonvested right. Factors indicating that a right would have existed regardless of the forfeiture include that the amount to which the service provider obtains a right is materially less than the present value of the forfeited amount multiplied by a fraction, the numerator of which is the period of service the service provider actually completed, and the denominator of which is the full period of service the service provider would have been required to complete to receive the full amount of the payment. Another factor is that the payment consists of a type of payment customarily made to service providers who separate from service with that service recipient and do not forfeit nonvested rights to deferred compensation (for example, a payment of accrued but unused leave or a payment for a release of potential claims).

2. Separation pay due solely to involuntary separation from service or participation in a window program

The final regulations generally continue the exception from coverage under section 409A in the proposed regulations for rights to payments available only upon an involuntary separation from service or participation in a window program, payable no later than the end of the second taxable year of the service provider following the year of the separation from service, and limited to an amount that is generally the lesser of two times the service provider's annual compensation or two times the limit on compensation set forth in section

401(a)(17). This exception only applies where the payment is available solely due to an involuntary separation from service of the service provider, or the service provider's participation in a window program, and not to a plan providing for a payment upon a voluntary separation from service or other event. For a discussion of when a separation from service for good reason may be treated as an involuntary separation from service, see section III.J.3 of this preamble.

Commentators requested that the exclusion continue to apply to payments up to the limit, even where the entire amount of the separation payments exceeds the limit. The final regulations adopt this rule. Accordingly, where a service provider is entitled to a payment that qualifies for the exception except that it exceeds the limit, only the excess over the limit will be subject to section 409A. The right to the payment up to the applicable limit will not be subject to section 409A, including the requirement that the payment be delayed for six months in the case of a specified employee, provided that such limited payment is otherwise required to be made, and is made, no later than the end of the second taxable year following the service provider's taxable year in which the separation from service occurs.

The final regulations clarify that for purposes of applying the section 401(a)(17) limit, the statutory limit applicable for the year of the separation from service occurs applies. The final regulations also clarify that for purposes of determining the service provider's annual rate of pay for the taxable year preceding the taxable year in which the separation from service occurs, an annual rate of pay based upon the service provider's taxable year immediately preceding the service provider's taxable year in which the separation from service occurs is used, adjusted for any increase during the year that was expected to continue indefinitely if the service provider had not separated from service. One commentator requested that the limit be set at twice the amount of compensation set forth under section 401(a)(17), regardless of the service provider's actual income. This suggestion has not been adopted in the final regulations.

3. Definition of involuntary separation from service

The proposed regulations provided an exclusion from coverage under section 409A that applied only to certain amounts paid solely because of an actual involuntary separation from service or participation in a window program. Many comments asked how to determine whether a separation from service is involuntary for this purpose. The final regulations contain a definition of involuntary separation from service and also apply this definition for purposes of the definition of a substantial risk of forfeiture, pursuant to which a payment that will not be made unless the service provider experiences an involuntary separation from service is subject to a substantial risk of forfeiture for purposes of section 409A. (See section V of this preamble).

The final regulations provide that whether a separation from service is involuntary is determined based on all the facts and circumstances. For this purpose, any characterization of the separation from service as voluntary or involuntary by the service provider and the service recipient in the documentation relating to the separation from service is rebuttably presumed to properly characterize the nature of the separation from service. For example, if a separation from service is characterized as voluntary, the presumption may be rebutted by demonstrating that absent the voluntary separation from service the service recipient would have terminated the service provider's services, and that the service provider had knowledge that the service provider would be so terminated.

Commentators requested that a separation from service for good reason be treated as an involuntary separation from service. The final regulations provide that where the right to a payment is contingent upon a voluntary separation from service following an occurrence that constitutes good reason for the service provider to terminate his or her services, the right may be treated as payable only upon an involuntary separation from service where the good reason condition is such that the service provider's separation from service effectively is an involuntary separation for purposes of section 409A. To be treated as an involuntary separation for purposes of section 409A, the avoidance of the re-

quirements of section 409A must not be a purpose of the inclusion of any good reason condition in the plan or of the actions by the service recipient in connection with the satisfaction of a condition. In addition, such good reason condition must require actions taken by the service recipient resulting in a material negative change in the employment relationship, such as a material negative change in the duties to be performed, the conditions under which such duties are to be performed, or the compensation to be received. Additional factors that may be relevant to whether a purported separation from service for good reason is the result of a *bona fide* good reason condition not having as a principal purpose the avoidance of section 409A include the extent to which the payments upon a separation from service for good reason are in the same amount and are made at the same time and in the same form as payments available upon an actual involuntary separation from service, and whether the service provider is required to give the service recipient notice of the existence of the good reason condition and a reasonable opportunity to remedy the condition. Where a good reason condition is sufficient to be treated for purposes of section 409A as a condition requiring an involuntary separation from service, an amount payable on account of a separation from service for good reason will be treated the same as an amount payable on account of an actual involuntary separation from service.

The final regulations also provide a safe harbor under which a provision for a payment upon a voluntary separation from service for good reason will be treated for purposes of section 409A as providing for a payment upon an actual involuntary separation from service. Those conditions include that the amount be payable only if the service provider separates from service within a limited period of time not to exceed two years following the initial existence of the good reason condition, and that the amount, time and form of payment upon a voluntary separation from service for good reason be identical to the amount, time and form of payment upon an involuntary separation from service. In addition, the service provider must be required to provide notice of the existence of the good reason condition within a period not to exceed 90 days of its initial existence,

and the service recipient must be provided a period of at least 30 days during which it may remedy the good reason condition. For these purposes, a good reason condition may consist of one or more of the following conditions arising without the consent of the service provider: (1) a material diminution in the service provider's base compensation; (2) a material diminution in the service provider's authority, duties, or responsibilities; (3) a material diminution in the authority, duties, or responsibilities of the supervisor to whom the service provider is required to report, including a requirement that a service provider report to a corporate officer or employee instead of reporting directly to the board of directors of a corporation (or similar entity with respect to an entity other than a corporation); (4) a material diminution in the budget over which the service provider retains authority; (5) a material change in geographic location at which the service provider must perform the services; or (6) any other action or inaction that constitutes a material breach of the terms of an applicable employment agreement.

4. *Collectively bargained plans*

Commentators requested an exception from coverage under section 409A to address certain plans providing for payments upon a voluntary separation from service, in the context of a collective bargaining agreement covering services performed for multiple employers. The Treasury Department and the IRS believe these issues are better addressed in the definition of separation from service. See section VII.C.2.b of this preamble.

5. *Treatment as a separate plan*

For purposes of the plan aggregation rules, the final regulations provide for separate treatment of plans providing for separation pay solely due to an involuntary separation from service or participation in a window program. This exception is intended to apply only where the amounts are payable solely due to an involuntary separation from service or participation in a window program, and not where the amounts may also become payable for some other reason, even where such payments actually are made due to an involuntary separation from service or participation in a window program.

Accordingly, any amount that would be paid as a result of a voluntary separation from service will not be included in this category. An arrangement that does not provide for deferred compensation will not be aggregated with a deferred compensation plan under this rule, merely because the arrangement not providing for deferred compensation accelerates vesting or payment upon an involuntary separation from service (for example, the acceleration of the vesting of a stock option or stock appreciation right that is excluded from coverage under section 409A).

6. *Reimbursement and fringe benefit plans*

a. *In general*

The proposed regulations provided that certain plans under which a service recipient reimburses certain types of expenses (for example, reasonable moving expenses or reasonable outplacement expenses directly related to a termination of the service provider's services) actually incurred by a service provider (including certain in-kind benefits provided to the service provider) following a separation from service are not nonqualified deferred compensation plans for purposes of section 409A, if such reimbursements are available only for expenses incurred, and the reimbursements are made, during a limited period (generally not after the second taxable year of the service provider following the separation from service).

In response to questions from commentators, the final regulations clarify that a right to a benefit that is excludible from income will not be treated as a deferral of compensation for purposes of section 409A. Accordingly, for example, an arrangement to provide health coverage excludible from income under section 105 generally would not be subject to section 409A.

Many commentators requested increased flexibility to provide for reimbursement arrangements upon a separation from service, including certain requests to exempt broad categories of such arrangements, such as the continuation of any plan in which the service provider participated while performing services. The Treasury Department and the IRS believe that an exemption from coverage under section 409A is not appropriate in such

circumstances, because such plans may provide for rights to significant amounts of deferred compensation over lengthy periods of time. However, the final regulations extend the limited period during which taxable reimbursements of medical expenses may be provided, to cover the period during which the service provider would be entitled (or would, but for such arrangement, be entitled) to continuation coverage under a group health plan of the service recipient under section 4980B (COBRA) if the service provider elected such coverage and paid the applicable premiums. In addition, the final regulations contain several provisions governing reimbursement plans (including plans providing in-kind benefits) that constitute nonqualified deferred compensation plans for purposes of section 409A, so that taxpayers will be able to design such arrangements to comply with the payment timing requirements of section 409A. For a discussion of these provisions, see section VII.B.2 of this preamble.

b. Specific exceptions for post-separation reimbursement plans

The final regulations continue to exclude from coverage under section 409A the reimbursement of certain expenses such as reasonable outplacement expenses and reasonable moving expenses for a limited period of time due to a separation from service, whether the separation from service is voluntary or involuntary. The final regulations, like the proposed regulations, require that the eligible expense must be incurred by the service provider no later than the end of the second year following the year in which the separation from service occurs. In response to questions from commentators, the final regulations clarify that the exception applies to the qualifying reimbursements available during the limited period of time, even if the plan extends beyond the limited period of time.

Several commentators requested that the limited period of time refer solely to the time the expense is incurred, and not the time the expense is reimbursed, to reflect the need for time to process the reimbursement request. Although the final regulations do not adopt this suggestion, the final regulations extend the period during which a service provider can receive a reimbursement payment by providing that

such payments must be made not later than the end of the third year following the separation from service. This extension applies only to reimbursements of expenses incurred by the service provider. Where the service recipient provides in-kind benefits (as defined in the regulations), or the service recipient pays a third party to provide in-kind benefits, such benefits must be provided by the end of the second year following the separation from service.

Commentators also requested that the final regulations clarify the treatment of rights to a reimbursement of any loss incurred due to a sale of a residence. The regulations clarify that for this purpose, reasonable moving expenses include the reimbursement of an amount related to a loss incurred due to a sale of a primary residence, provided that the reimbursement does not exceed the loss actually incurred.

7. Limited payments of separation pay

The final regulations provide that, if not otherwise excluded, a taxpayer may treat a right or rights under a separation pay plan to a payment or payments of an aggregate amount not to exceed the applicable dollar amount under section 402(g)(1)(B) for the year of the separation from service as not providing for a deferral of compensation. Commentators raised questions concerning the calculation of the excluded amount, and requested an increase in the amount. The limited payment exception is intended to avoid the application of section 409A to incidental benefits often provided upon a separation from service, where the parties may not realize that the benefits are nonqualified deferred compensation. The exception is not intended to address extended or significant benefits. Accordingly, the final regulations do not substantially increase the amount of the exclusion. However, to permit the excluded amount to automatically reflect cost-of-living increases, the maximum exclusion now equals the maximum amount of an elective deferral permitted under section 402(g) for the year of the separation from service.

The aggregate amount refers to the aggregate amount of payments to which the service provider has a right or rights. The exclusion may be applied to any type of separation pay plan, but may apply only once with respect to amounts paid by a ser-

vice recipient to a service provider. So, for example, if a service provider treats a right to a payment of separation pay equal to the applicable limit under section 402(g) in the first year following a separation from service as an excluded right, the right to the amount is not treated as a deferral of compensation regardless of when the amount is actually paid (though other provisions of the Code and the constructive receipt doctrine continue to apply). However, once the right is treated as excluded, the service provider may not treat any other right with respect to the service recipient, such as an additional right to a payment equal to the applicable limit under section 402(g) in the second year following the separation from service, as excluded under this exception.

K. Non-taxable benefits

The final regulations clarify that a legally binding right to receive a non-taxable benefit does not provide for a deferral of compensation for purposes of section 409A, unless the service provider has received the right in exchange for, or has the right to exchange the right for, an amount that will be includible in income (other than due to participation in a cafeteria plan described in section 125). In addition, because such benefits do not provide for a deferral of compensation, the plan aggregation rules will not result in taxation of other benefit plans merely because the terms of such nontaxable benefit arrangements would not comply with section 409A if the arrangement were covered by section 409A. For a discussion of the requirements for a taxable reimbursement plan to satisfy the payment timing requirements of section 409A, see section VII.B.2 of this preamble.

L. Legal settlements

Commentators requested clarification of the application of section 409A to amounts paid pursuant to litigation between the service provider and service recipient, including both court awards and *bona fide* settlements, and including amounts characterized as wages or otherwise treated as replacing compensation. The Treasury Department and the IRS believe that section 409A was not intended to govern settlements or awards resolving *bona fide* legal claims based on

wrongful termination, employment discrimination, the Fair Labor Standards Act, or worker's compensation statutes, regardless of whether such claims arise under Federal, state, local, or foreign laws, even where settlements or awards pursuant to such claims are treated as compensation for Federal tax purposes. The final regulations generally treat such arrangements as not providing for deferred compensation for purposes of section 409A. In addition, the final regulations generally provide that section 409A does not apply to the payment of, or reimbursement for, attorney's fees incurred in connection with the enforcement of such a claim. However, the exception covers only rights arising from the *bona fide* claim, and is not intended to allow such settlements or awards to act as substitutes for, or to allow for the restructuring of, preexisting deferred compensation subject to section 409A. For example, a change to the timing of the payment of a pre-existing amount of deferred compensation as part of such a settlement would be subject to the rules governing accelerated payments and subsequent deferral elections. In addition, the payment of an amount upon the execution of a waiver of any or all of such claims does not necessarily indicate that the amounts are paid as an award or settlement of an actual *bona fide* claim. Rather, to qualify for the exception under this provision, the amounts must be paid with respect to an actual *bona fide* claim for damages under the applicable law. For a discussion of the treatment of settlements of *bona fide* disputes regarding the right to preexisting deferred compensation subject to section 409A, see section VIII.G of this preamble.

M. *Split-dollar life insurance arrangements*

Some commentators requested that split-dollar life insurance arrangements be excluded from coverage under section 409A. Split-dollar life insurance arrangements are often used as a method of providing deferred compensation and there is no indication in the statute or legislative history of any legislative intent that such arrangements be excluded from coverage under section 409A. In addition, like a promise to transfer property in the future, a promise to transfer an economic benefit

in the future may provide for deferred compensation. Accordingly, a split-dollar life insurance arrangement may provide for deferred compensation, and whether a split-dollar life insurance arrangement provides for deferred compensation must be determined through application of the general rules defining deferred compensation and a nonqualified deferred compensation plan. In response to requests for additional guidance, the Treasury Department and the IRS anticipate issuing a notice addressing the application of section 409A to split-dollar life insurance arrangements.

Commentators raised issues concerning the interplay between the modifications that may be needed to satisfy the requirements of section 409A and the effective date rules applicable to split-dollar life insurance arrangements under §1.61-22(j). Commentators pointed out that the modifications necessary to meet the requirements of section 409A and these regulations may cause the arrangement to be treated as a new arrangement under §1.61-22(j) and requested relief. The notice will also address this issue.

N. *Educational benefits*

Commentators requested an exclusion from coverage under section 409A for promises to provide future taxable educational benefits to service providers. These benefits typically would be provided as an inducement to provide a period of services. Commentators expressed concern that the amount and timing of the payment of such benefits would be difficult to ascertain, because the amount and timing of the payments would depend upon the service provider's decisions with respect to further education. The final regulations generally provide an exception from coverage under section 409A for rights to educational benefits, where the benefits consist solely of educational assistance (as defined for purposes of section 127(c)) provided solely for the education of the service provider.

IV. *Definition of Plan*

A. *Plan aggregation rules*

The proposed regulations generally provided that all amounts deferred with respect to a service provider under all

plans of a service recipient falling within a particular category would be treated as deferred under a single plan. The enumerated categories included amounts deferred under account balance plans, amounts deferred under nonaccount balance plans, amounts deferred under separation pay plans providing payments due solely to an involuntary termination or participation in a window program, and amounts deferred under any other plan. The final regulations adopt these provisions, subject to certain modifications described in this preamble.

The final regulations provide that the bifurcation rules applicable to plans under §31.3121(v)(2)-1(c)(1)(iii)(B), which are permissive for purposes of the application of section 3121(v)(2), must be applied for purposes of the plan aggregation rules under section 409A. Accordingly, a portion of a nonqualified deferred compensation plan is a separate account balance plan if that portion otherwise qualifies as an account balance plan and the amount payable to service providers under that portion is determined independently of the amount payable under the other portion of the plan.

The final regulations also provide additional categories of plans for purposes of the aggregation rules. One category covers split-dollar life insurance arrangements. Another category is comprised of reimbursement plans, providing for the reimbursement of expenses incurred or the provision of in-kind benefits (as defined in the regulations), to the extent the right to such benefits or reimbursements, separately or in the aggregate, does not constitute a substantial portion of the overall compensation earned by the service provider for performing services for the service recipient, or the overall compensation received due to a separation from service. Stock rights that constitute nonqualified deferred compensation for purposes of section 409A also comprise a separate category.

The final regulations further provide for account balance plans to be subdivided into a category for elective plans and a category for nonelective plans. Plans will only be subdivided in this manner to the extent the amounts deferred under an elective deferral arrangement (and earnings on such amounts) may be separately identified. For this purpose, a right to a match on an elective deferral will not be treated as an elective deferral arrangement.

In an additional category, any amounts deferred under a foreign plan may be treated as deferred under a separate plan from any amounts deferred under a domestic plan, provided that the deferrals under the plan are deferrals of amounts that would be treated as modified foreign earned income (meaning foreign earned income as defined under section 911(b)(1) without regard to section 911(b)(1)(B)(iv) and without regard to the requirement that the income be attributable to services performed during the period described in section 911(d)(1)(A) or (B)) if paid to the service provider at the time the amount is first deferred, and provided further that the foreign plan is not substantially identical to a domestic plan in which the service provider participates. For this purpose, a foreign plan is a plan that the service recipient provides primarily to nonresident aliens or resident aliens classified as resident aliens solely under section 7701(b)(1)(A)(ii) (and not section 7701(b)(1)(A)(i)).

B. Written plan requirement

Commentators requested clarification and simplification of the provisions required to be included in writing in plan documents to comply with section 409A. As a general rule, the final regulations provide that to satisfy the requirement that a plan be in writing, the document or documents constituting the plan must specify, at the time an amount is deferred, the amount to which the service provider has a right to be paid (or, in the case of an amount determinable under an objective, nondiscretionary formula, the terms of such formula), and the payment schedule or payment triggering events that will result in a payment of the amount.

A plan must provide for the six-month delay requirement applicable to payments to specified employees upon a separation from service no later than the time the provision may become applicable to a separation from service of the specified employee. Accordingly, the plan must contain the provision by the time at which the employee becomes a specified employee (either because the stock of a component of the service recipient becomes publicly traded, or because the specified employee effective date has been reached for a list of specified employees that includes the em-

ployee). A provision applicable to a plan sponsored by a service recipient or a plan in which a specified employee participates is effective with respect to a specified employee only to the extent the provision is binding on the employee.

With respect to a deferral election, whether an initial or subsequent deferral election, the plan must specify no later than the time by which that election is required to be irrevocable the conditions under which that election may be made. With respect to permitted accelerations of a payment, the plan need not specify the conditions under which the accelerated payment will be made except as explicitly required in these regulations. However, the taxpayer must demonstrate that the acceleration of the payment complies with the requirements of section 409A and these regulations.

Commentators also requested clarification regarding whether the requirement that a plan be in writing also means that the plan must be contained in a single document. For purposes of this rule, the plan consists of all documents that together define the service provider's rights to the compensation. Accordingly, the terms of a plan document may be contained in more than one document including, for example, a deferral election document.

Commentators asked whether a savings clause would be sufficient to ensure compliance with section 409A, where the savings clause provides that each provision of the plan will be interpreted to be consistent with the requirements of section 409A and that any provision of the plan that does not satisfy such requirements will be of no force or effect. The final regulations provide that for purposes of determining the terms of a plan, general provisions of the plan that purport to nullify noncompliant plan terms, or to supply required specific plan terms, are disregarded. Accordingly, if a plan contains terms that do not meet the requirements of section 409A and these regulations, or fails to contain a plan term necessary to meet the requirements of section 409A and these regulations, the plan will violate the requirements of section 409A and these regulations regardless of whether the plan contains such a savings clause.

Several commentators requested that the Treasury Department and the IRS publish model amendments. Due to the

complex and varied universe of deferred compensation plans, the Treasury Department and the IRS do not believe that it is feasible to publish model amendments at this time.

V. Definition of Substantial Risk of Forfeiture

A. In general

The final regulations generally adopt the definition of substantial risk of forfeiture set forth in the proposed regulations. Several commentators requested that the definition of substantial risk of forfeiture be the same as the definition of substantial risk of forfeiture in §1.83-3(c). However, the definition of substantial risk of forfeiture for purposes of compensatory transfers of property under section 83 reflects different policy concerns from those involved in section 409A, and there are also practical differences between transfers of restricted property and promises to pay deferred compensation. This is reflected in the provisions of section 409A(e)(5), directing the Secretary of the Treasury Department to issue regulations disregarding a substantial risk of forfeiture in cases where necessary to carry out the purposes of section 409A. Accordingly, the final regulations do not adopt this suggestion.

A right to an amount deferred may be subject to the satisfaction of two or more different conditions that each independently would be a substantial risk of forfeiture. In that case, the substantial risk of forfeiture generally would continue until all of such conditions had been met. Alternatively, a right to an amount deferred may be subject to the satisfaction of any of two or more different conditions that each independently would constitute a substantial risk of forfeiture. In that case, the substantial risk of forfeiture generally would lapse as soon as one of the conditions had been met.

The final regulations explicitly provide that a payment conditioned on an involuntary separation from service without cause may be treated as subject to a substantial risk of forfeiture if there is a substantial risk that the service provider will not be involuntarily separated from service without cause. Many of the comments relating to the definition of a substantial risk of forfeiture requested also that a benefit available

only upon a separation from service for good reason be treated as subject to a substantial risk of forfeiture. Under the definition of an involuntary separation from service provided in the final regulations, the right to a payment upon a separation from service for good reason may, in certain circumstances, be treated as a right to a payment upon an involuntary separation from service. For a discussion of the definition of an involuntary separation from service, see section III.J.3 of this preamble.

Commentators requested that a requirement that an employee sign a release of claims to receive a benefit be treated as a substantial risk of forfeiture. Generally, conditions under the discretionary control of the service provider (other than the decision whether or not to continue providing services) are not treated as creating a substantial risk of forfeiture. Accordingly, the final regulations do not adopt this suggestion.

One commentator suggested that any right to a payment be treated as subject to a substantial risk of forfeiture until the amount of the payment is readily determinable, at least where the payment could be zero. The Treasury Department and the IRS do not believe that this standard is appropriate.

B. Election between vested and nonvested rights

The final regulations provide that an amount will not be considered subject to a substantial risk of forfeiture after the date or time at which the recipient otherwise could have elected to receive the amount of compensation, unless the present value of the amount purportedly subject to a substantial risk of forfeiture (disregarding, in calculating the present value, the risk of forfeiture) is materially greater than the present value of the vested amount the recipient otherwise could have elected to receive. For example, if a service provider can elect to receive, in lieu of a payment of current compensation, a bonus based upon a formula that would otherwise subject the bonus to a substantial risk of forfeiture, the bonus will be subject to a substantial risk of forfeiture for purposes of section 409A only if the present value of the amount of the bonus (disregarding the risk of forfeiture) is materially greater than the present value of the current compensation amount.

Some commentators asked whether this exception addressed the extension of a substantial risk of forfeiture as part of the negotiated extension of an employment contract. Commentators argued that rights a service provider obtains under a new or extended employment contract could be viewed as a right to an amount materially greater than the amount the service provider otherwise could have received. The final regulations clarify that for purposes of this rule, compensation the service provider would receive for continuing to perform services regardless of whether the service provider elected to receive the vested payment is not taken into account for purposes of determining whether the present value of the right to the nonvested payment is materially greater.

VI. Initial Deferral Election Rules

A. In general

The final regulations adopt the provisions contained in the proposed regulations relating to initial deferral elections, subject to the modifications described in this preamble.

The proposed regulations generally provided that in a nonelective plan, a service recipient may designate the time and form of payment on or before the date the service provider obtains a legally binding right to the payment. Commentators requested clarification of how the service recipient's discretion to designate a time and form of payment related to the requirement in the proposed regulations that a service provider's deferral election be irrevocable by the applicable deadline. Specifically, commentators requested that a deferral election by a service provider be treated as irrevocable, even if during the period during which the service recipient could have set the time and form of payment (that is, through the date the service recipient grants the service provider a legally binding right to the payment), the service recipient retains the right to override the service provider's deferral election and provide for deferral of a lesser or greater amount. The final regulations do not adopt this suggestion. If a service provider may make an initial deferral election, including an election as to the time and form of payment, the election must be irrevocable as of the date

required under the rules governing such service provider elections. Accordingly, a plan may not provide for such an override, unless such override cannot occur after the deadline by which the service provider's election must be effective.

Many commentators requested a clarification of the rules with respect to a deferral of a discretionary bonus, where the legally binding right to the bonus does not arise until a year subsequent to the year in which services are performed. For example, an employer announces in 2010 that it will be awarding discretionary bonuses for services performed in 2011, and will decide which employees will receive bonuses and in what amounts at the beginning of 2012. Section 409A(a)(4) generally provides that compensation for services performed during a taxable year may be deferred at the service provider's election only if the election to defer such compensation is made not later than the close of the taxable year preceding the year in which the services are rendered. Accordingly, even where the bonus is discretionary such that the legally binding right to the bonus does not arise until after the period of services for which the bonus is paid has begun, a service provider's deferral election must occur before the year in which the period of services begins absent some other applicable exception (such as, for example, the deferral election rules related to performance-based compensation). The determination of the period of services for which compensation is earned is based on all the facts and circumstances, but may include periods of service before the date the service provider obtains a legally binding right to the compensation. Although not necessarily determinative, one of the factors taken into account in that determination is a designation by the service recipient of the period of services for which the compensation is earned.

B. Nonelective deferrals

Commentators pointed out that under the proposed regulations, a service recipient might be required to designate a time and form of payment with respect to a nonelective deferral at an earlier date than the service provider would have to make such a designation if an election had been provided to the service provider. Commentators requested that the service recipient

be provided the same flexibility as the service provider in such cases. The final regulations generally adopt this suggestion, so that if the service provider has no election as to the time and form of payment of an amount of deferred compensation, the service recipient may set the time and form of payment on any date on or before the later of the latest date the service provider would have been permitted under these regulations to elect such time and form of payment if an election had been provided to the service provider, or the date the service recipient grants the legally binding right to the compensation. So, for example, where compensation is performance-based compensation, and the service recipient retains the discretion to establish the time and form of the payment, the plan generally could permit the service recipient to establish the time and form of the payment on or before the date six months before the end of the relevant performance period.

C. Performance-based compensation

The final regulations generally adopt the definition of performance-based compensation contained in the proposed regulations, subject to the modifications described in this preamble. The final regulations clarify that where a portion of an award would qualify as performance-based compensation if the portion were the sole amount available under the plan, that portion of the award will not fail to qualify as performance-based compensation merely because another portion of the award does not qualify as performance-based compensation, if the portion that would qualify as performance-based compensation is designated separately or otherwise separately identifiable under the terms of the plan and each portion is determined independently of the other.

Commentators asked whether in order to use the deferral rules regarding performance-based compensation, a service provider must be required to perform services during the entire performance period, or from the date the performance criteria are set through the end of the performance period. Commentators argued that because a payment cannot be substantially certain to be made at the time of the deferral election under the deferral election rules applicable to performance-based

compensation, a service provider's ability to manipulate the timing of income inclusion under a performance-based compensation arrangement is limited. The final regulations require only that the service provider provide services from the later of the date the performance period starts or the date the performance criteria are established through the date the initial deferral election is made.

Commentators suggested that a provision in a plan for automatic payment to occur upon death, disability, or a change in control event (as defined for purposes of section 409A) should not result in a failure of the arrangement to qualify as performance-based compensation. The final regulations adopt this suggestion, provided that where such an event occurs before a deferral election has been made, the right to the payment will no longer be treated as performance-based compensation so that a deferral election may not be effective unless made in accordance with another applicable deferral election rule.

In response to comments, the requirement that a deferral election under the rule applicable to performance-based compensation be made before the compensation has become substantially certain to be paid has been modified, and now requires that the election be made before the amount is readily ascertainable. Where the right to a specified amount is subject to a performance requirement being met (for example, a right to a payment of \$10,000 if a certain profit level is attained), the amount is treated as readily ascertainable when it is substantially certain that the performance requirement will be met. With respect to the right to an amount of compensation that varies based upon the level of performance, the payment, or any portion of the payment, is treated as readily ascertainable to the extent the amount or the payment is calculable and the performance requirement is substantially certain to be met. For this purpose, a right to a payment is bifurcated between the amount that is readily ascertainable and the amount that is not readily ascertainable. Accordingly, any minimum amount that is calculable and for which the performance requirement entitling the service provider to the payment is substantially certain to be met generally will be treated as readily ascertainable.

For example, a service recipient agrees to pay \$100 for every additional widget

meeting certain quality requirements that is produced in a calendar year in excess of 100 widgets. At the end of the six months, 125 widgets have been produced and no election to defer has been made. As of that date, the performance-based compensation with respect to which an election to defer can be made does not include the \$2500 ((125-100) multiplied by \$100) that is calculable and for which the performance requirement is substantially certain to be met. In addition, the performance-based compensation does not include any additional amount that the service provider is substantially certain to earn based on the number of additional widgets that the service provider is substantially certain to produce before the end of the year. However, the payment is bifurcated so that any additional amount that is not substantially certain to be paid may be treated as performance-based compensation such that an election to defer such compensation may be made.

Commentators requested clarification of the circumstances under which compensation, the amount of which is determined by reference to the value of service recipient stock, may qualify as performance-based compensation. The fair market value of stock at any given time generally incorporates the market's perception of the probability that the stock will increase or decrease in value. Accordingly, compensation payable for a service period that is equal to the value of a predetermined number of shares of stock, and is variable only to the extent that the value of such shares appreciates or depreciates, generally will not be performance-based compensation. However, if the right to such compensation is subject to a performance-based vesting requirement, such compensation may be performance-based compensation. Also, the attainment of a prescribed value for the service recipient (or a portion thereof), or a share of stock of the service recipient, may be used as a performance-based criterion, if it is a condition for receiving the compensation and the other requirements are met.

D. Initial eligibility

Section 409A(a)(4)(B)(ii) provides that in the case of the first year in which a service provider becomes eligible to participate in the plan, an initial deferral elec-

tion may be made within 30 days after the date the service provider becomes eligible to participate in the plan, with respect to compensation for services to be performed subsequent to the election. The final regulations adopt the provisions implementing the initial eligibility deferral election rules set forth in the proposed regulations, subject to the following modifications.

Many of the commentators on the initial eligibility deferral election rule expressed concerns about the application of the plan aggregation rules. The proposed regulations provided that the plan aggregation rules would apply in determining whether a service provider was newly eligible for a plan, so that if a service provider was already participating in an arrangement that is required to be aggregated with the arrangement for which the service provider is initially eligible, the service provider would not be able to take advantage of the initial eligibility deferral election rule. Some commentators requested that the plan aggregation rules not apply for this purpose. However, the Treasury Department and the IRS believe that such a rule would result in the potential for the adoption of serial plans as a means to claim repeated initial eligibility and the ability thereby to make late deferral elections. In addition, such a rule would require difficult determinations of whether one plan was sufficiently dissimilar from another plan to qualify as a separate plan.

Other commentators requested that the plan aggregation rules apply, but that plans allowing elections between current and deferred compensation, or the part of a plan allowing such elections, be treated separately from nonelective plans or nonelective benefits in each category. The final regulations generally adopt this rule through the modifications to the plan aggregation rules described in section IV.A of this preamble.

Other comments focused on the application of the initial eligibility deferral election rule in the case of a rehire or a change in position within a service recipient. Commentators pointed out that under the standard in the proposed regulations, if an employee had not received a distribution after the initial termination of employment, or had transferred to a position not participating in the plan without receiving a distribution and then transferred back to a position participat-

ing in the plan, the rehired or returning employee would still retain the right to benefits under the plan and thus would not be able to use the initial eligibility deferral election rules. The final regulations provide that the initial eligibility deferral election rules are applicable to a service provider provided that the service provider has not been an active participant in the plan (applying the plan aggregation rules) for at least 24 months. For this purpose, a service provider is an active participant in the plan if, under the plan's terms and without further amendment or action by the plan sponsor, the service provider is eligible to accrue benefits under the plan (even if the service provider has elected not to participate in the plan), other than earnings on amounts previously deferred.

Commentators requested relief with respect to the timing rules for initial elections establishing the time and schedule of payments under nonelective excess benefit plans. Commentators noted that under such plans, a service provider often automatically becomes a participant when the service provider's benefits under the qualified plan become limited under the rules governing qualified plans. Because determining whether a service provider is a participant requires calculations, commentators observed that both the service provider and the service recipient may be unaware that the service provider has become a participant in the plan for some time after the service provider actually first becomes eligible. The final regulations generally provide that with respect to a nonelective excess benefit plan, a service provider is treated as initially eligible to participate in the plan as of the first day of the service provider's taxable year immediately following the first year the service provider accrues a benefit under such plan, so that an initial deferral election with respect to the time and form of payment may be effective for benefits accrued under the plan based on services performed during the taxable year immediately preceding the year in which the election is made. This rule may only be used once with respect to a service provider's participation in a plan.

E. Initial deferral elections with respect to certain forfeitable rights

The proposed regulations provided a rule for initial deferral elections with re-

spect to certain forfeitable rights, generally intended to address *ad hoc* awards. Under the rule in the proposed regulations, if a legally binding right to a payment in a subsequent year is subject to a forfeiture condition requiring the service provider's continued services for a period of at least 12 months from the date the service provider obtains the legally binding right, an election to defer such compensation may be made on or before the 30th day after the service provider obtains the legally binding right to the compensation, provided that the election is made at least 12 months in advance of the earliest date at which the forfeiture condition could lapse. The final regulations retain this rule, subject to the modifications described in this preamble.

Commentators suggested that the requirement of at least a 12-month service period following the deferral election during which the right could be forfeited due to a separation from service be shortened to 11 months, because the combination of the 30-day election period plus the 12-month service period requirement generally resulted in a requirement of at least a 13-month performance period. The requirement of a 12-month service period after an election is made ensures that the election occurs while at least an entire year (12 months) of services is still required. This conforms in many respects to the general rule that the deferral election must be made in the year before the year in which the services are performed. Any shorter period would permit service providers to make deferral elections in the same taxable year in which all of the services are performed. The Treasury Department and the IRS do not believe that such a rule is consistent with the legislative intent.

The final regulations also provide that this rule is available even if the right to the compensation may vest earlier than 12 months following the election due to the service provider's death or disability, or due to a change in control event (as defined for purposes of section 409A) with respect to the service recipient. However, if death, disability, or a change in control event occurs and the condition lapses before the end of such 12-month period, a deferral election may be given effect only if the deferral election is permitted under the regulations without regard to this rule.

F. Initial deferral election with respect to fiscal year compensation

The final regulations retain the initial deferral election rule with respect to fiscal year compensation that was in the proposed regulations. The final regulations clarify that the rule with respect to the deferral of fiscal year compensation is based upon the service recipient's taxable year, regardless of whether the service recipient's taxable year is the calendar year or some other period. Accordingly, where a service recipient with a calendar year taxable year is providing fiscal year compensation to a service provider based upon a calendar year, a service provider with a non-calendar year taxable year generally could take advantage of the rule to defer such fiscal year compensation on or before the December 31 preceding the calendar year upon which the fiscal year compensation is based.

G. Initial deferral elections with respect to commissions

The final regulations continue to provide a special deferral election rule with respect to commission payments. These rules are intended to address concerns that, for many commission arrangements, it is difficult to determine when the services related to a particular commission payment began, so that it is difficult to apply the general rule that requires that a deferral election be made before the year in which any services are performed. This rule is not intended to address whether, absent such a deferral election, a particular commission arrangement would result in deferred compensation. Whether a commission arrangement otherwise provides for deferred compensation must be determined through the application of the general rules defining deferred compensation. However, where a commission arrangement requires that the service provider be providing services at the time of the payment to be entitled to the payment, the commission is paid in the normal course, and neither the service provider nor the service recipient has a right to specify a payment date, the arrangement generally will not provide for the deferral of compensation.

The final regulations generally adopt the deferral election rule set forth in the

proposed regulations treating the services related to a commission payment as performed in the year in which the customer remits payment to the service recipient. For this purpose, the proposed regulations provided that commissions include only compensation contingent upon the service recipient receiving payment from an unrelated customer for the product or services provided.

Commentators asked that this rule be extended to cover arrangements under which the service recipient paid the commission based upon consummation of a transaction, regardless of whether the customer paid the service recipient for the service or good purchased from the service recipient. For example, commentators stated that in some industries the service recipient pays a salesperson commissions based on the amount of sales recorded, even though the customer is not obligated to pay the service recipient until a later date. The final regulations generally adopt this suggestion by permitting the taxable year in which the sale occurs to be substituted for the year in which the customer remits payment. However, to avoid manipulation of the deferral election timing rules, the taxable year of the sale may be used only if it is applied consistently to all similarly situated service providers.

Commentators also asked that this rule be extended to commissions earned due to the increase in value, or maintenance of overall value, of a pool of assets or accounts. In response, the final regulations provide that, for purposes of the initial deferral election rules, the services with respect to investment commission compensation are deemed to be performed over the 12 months immediately preceding the date as of which the overall value of the assets or asset accounts is determined for purposes of the calculation of the investment commission compensation. For this purpose, investment commission compensation means compensation earned by a service provider if a substantial portion of the services provided by such service provider to a service recipient consists of sales of financial products or the provision of other direct customer services to an unrelated customer with respect to customer assets or customer asset accounts. For this purpose, amounts will only be treated as investment commission compensation if the

customer retains the right to terminate the customer relationship and transfer or withdraw the assets or asset accounts without undue delay (which may be subject to a reasonable notice period), the compensation paid by the service recipient to the service provider consists of a portion of the value of the overall assets or asset account balance, an amount substantially all of which is calculated by reference to the increase in the value of the overall assets or account balance during a specified period, or both, and the value of the overall assets or account balance and investment commission compensation is determined at least annually.

Commentators also requested that the exception for commissions be expanded to address arrangements involving customers related to either the service provider or the service recipient. The Treasury Department and the IRS are concerned that where arrangements involve related parties, there is the potential for manipulation of the timing of the payment and the commission, but also understand that many of such arrangements may not involve abuse. Therefore, the final regulations provide that the special rules with respect to commissions apply to arrangements involving a customer related to the service provider or the service recipient provided that substantial sales or substantial services occur between the service recipient and a significant number of unrelated customers, and the sales or service arrangement and the commission arrangement with respect to a customer related to either the service recipient or the service provider are *bona fide* and arise in the ordinary course of business, and both the terms and practices are substantially the same as the terms and practices applicable to customers to whom the service provider and service recipient are not related, and to whom, either individually or in the aggregate, the service recipient has made substantial sales or provided substantial services.

H. Involuntary and voluntary separations from service

The final regulations provide that with respect to separation pay paid upon an actual involuntary separation from service, where the service provider had no prior right to such separation pay, and where the separation pay is the subject of *bona fide*,

arm's length negotiations, the initial deferral election may be made at any time before the service provider obtains a legally binding right to the payment. The final regulations expand this rule to include voluntary separations from service as well as involuntary separations, as long as all of the other conditions in the previous sentence are met. The exception addresses both a choice between a current and a deferred payment, and the establishment of the time and form of payment of deferred compensation.

The exception is intended to address legally binding rights to deferred compensation arising as part of the process of separating from service and not based upon previously existing legally binding rights. The exception is intended to alleviate concern that where such rights are expressed or calculated based on prior compensation or service, any election by the service provider as to the timing of the payment during the negotiation process could be viewed as a late initial deferral election made during or after the year in which the services were performed, and to avoid the potential for the plan aggregation rules to eliminate the ability to make an initial eligibility deferral election. The Treasury Department and the IRS have become aware that certain taxpayers have attempted to apply this provision to existing deferred compensation plans, believing that the exception allows new elections provided that the separation pay was the subject of *bona fide* negotiations. This application is inconsistent with the explicit provision of the proposed regulations and these final regulations. The provision does not address preexisting legally binding rights to deferred compensation, including legally binding rights that are subject to a substantial risk of forfeiture. Any change in the time and form of payments under those arrangements would be required to meet the rules governing subsequent deferral elections and accelerated payments (including any applicable relief provided during the transition period). For a discussion of the treatment of benefits forfeitable upon the separation from service, see section III.J.1 of this preamble.

I. Elections to annualize recurring part-year compensation

Commentators asked how the deferral election rules would apply to an election by certain employees providing services over less than a 12-month period to receive payments for services on an annualized basis. For example, teachers performing services during a school year running from September of one year through June of the next year often are provided an election to receive the compensation on an annualized basis over 12 months instead of during only the school year. This raises issues under the general initial deferral election rules under section 409A because the teacher is permitted to elect after the beginning of the calendar year to defer some of the compensation that would be paid in September through December of that year to a period in the subsequent year.

The final regulations provide that with respect to recurring part-year compensation, an election to defer all or a portion of the compensation to be earned during a particular period of service may be made at any time before the period of service begins, provided that no amounts are deferred under the election to a date after the last day of the 13th month following the first day of the performance period. For this purpose, recurring part-year compensation is defined as compensation paid for services rendered in a capacity that the service recipient reasonably anticipates will continue in subsequent years on similar terms and conditions, and will require services to be provided over successive service periods of less than 12 months, each of which begins in one taxable year of the service provider and ends in the next such taxable year. For example, a teacher earning compensation from September 15 of one year through June 30 of the subsequent year could elect to defer compensation earned during such period on any date on or before September 15 of the first year, provided that no amount deferred in accordance with this rule is deferred beyond October 31 of the following year. This exception may be applied to a particular amount of compensation only once, so that an amount deferred under this exception may not be deferred a second time through treatment of the amount as earned in a subsequent service period.

J. USERRA

The final regulations provide that the initial deferral election rules are deemed satisfied to the extent that a deferral election provided to a service provider is necessary to satisfy the requirements of the Uniformed Services Employment and Reemployment Rights Act of 1994, as amended, 38 U.S.C. 4301–4334. Similar relief has been provided with respect to changes in the time and form of payment and accelerations of payments.

VII. Time and Form of Payment

A. In general

The final regulations clarify that except as explicitly provided otherwise, a single time and form of payment must be designated with respect to each payment that is payable upon a payment event. For example, a plan must designate how an amount will be paid upon a change in control event, and generally cannot provide one time and form of payment upon a particular type of change in control event, and another time and form of payment upon another type of change in control event. The final regulations retain the rule, however, that permits a plan to provide for a different time and form of payment, depending upon whether the permissible payment event occurs before or after a specified date. In addition, the final regulations also provide for a limited ability to designate different times and forms of payment based upon the conditions under which a service provider's separation from service occurs. See section VII.C.5 of this preamble for a discussion of payments upon a separation from service.

The proposed regulations provide that for purposes of applying the payment rules, a payment will be treated as made on a fixed date or on a fixed schedule if the payment or payments are made by the end of the calendar year in which a specified fixed payment date, or due date of a payment under a fixed schedule, occurs or, if later, the 15th day of the third month following such fixed date or due date. The final regulations clarify that the same flexibility applies to making a payment on account of a payment event. So, for example, where a payment is scheduled to be made upon the death of a service provider

whose taxable year is the calendar year, the payment is timely if made on or before the later of December 31 of the calendar year in which the death occurs, or the 15th day of the third month following the date of death. If the service provider's taxable year is not the calendar year, the final regulations specify that the service provider's taxable year is used for purposes of this rule.

Commentators also requested that where a payment is scheduled to be made on a fixed date, a service recipient be permitted to pay at any preceding date within the same calendar year. Commentators argued that if the regulations permitted a payment to be made later within the same calendar year because the amount would be reflected on the same income tax return in the case of an individual service provider, then the same rationale should permit payments to be made earlier in the same calendar year. Because the adoption of this provision would conflict with the administration of the rules governing subsequent deferrals, the final regulations do not adopt this suggestion.

The subsequent deferral rules require that any election to extend the deferral period must not be effective for at least one year after the date the payment is due. If a payment due on a specified date during a calendar year could always be made on January 1 or any subsequent date during the calendar year, then the one-year waiting period would have to begin to run on the previous January 1, regardless of the actual payment date the plan specified.

For example, if a plan specified December 31 as the payment date, but the payment could be made on January 1, then any subsequent deferral election would need to be made on or before January 1 of the preceding calendar year, making the deadline for a subsequent deferral election almost two years before the actual specified payment date. Such a rule would unduly burden service providers who cannot actually receive a payment before the date specified in the plan. However, to lower the potential for unintentional violations, the final regulations provide that a payment will be deemed made at the scheduled time of payment if made not earlier than 30 days before the scheduled date, provided that the service provider is not permitted, directly or indirectly, to designate the taxable year of the payment.

In addition, the final regulations continue to provide that a plan may designate an entire taxable year of the service provider, rather than a specific date, as the specified date of payment. If a plan provides only for the taxable year of payment, the payment may be made at any time during such year. For purposes of the subsequent deferral rules, the payment will be treated as scheduled to be paid on the first day of the service provider's taxable year.

Commentators also requested clarification of the treatment of deadlines for payment, where the plan does not designate a specific payment date or taxable year of the service provider. For example, commentators asked whether a provision requiring payment as soon as administratively feasible but in no event later than the 15th day of the third month following the end of the year would be treated as having a fixed date of payment. The final regulations provide that such a provision will be a specified payment date only if the period during which such payment may be made is restricted either to a specified taxable year of the service provider or a period of not more than 90 days and the service provider is not provided an election as to the taxable year of the payment. If a specific payment date is not established, the first possible date on which a payment could be made under the plan is the specified payment date for purposes of the rules relating to subsequent deferral elections. For example, a payment scheduled to be made at any time on or after January 1, 2008, and on or before July 1, 2008, to a service provider whose taxable year is the calendar year will be deemed to have a fixed payment date. For purposes of the subsequent deferral rules, January 1, 2008, is the specified payment date.

By contrast, a payment scheduled to be made to such a service provider at any time on or before July 1, 2008, would not be deemed to have a fixed payment date, because the payment could be made before January 1, 2008. In addition, a payment scheduled to be made to a service provider, for example, within 180 days of a separation from service generally will not provide for a specified time and form of payment under the final regulations, because it specifies neither the taxable year of the service provider in which the payment must be made following the separation from service, nor a period of 90

days or less following the separation from service in which the payment must be made. Because such a payment schedule would not provide an objective payment date based upon the separation from service event, the payment also would not be eligible for the relief provided for payments made by the later of the end of the taxable year of the service provider or the 15th day of the third month following the specified payment date. However, a plan provision providing that the payment will be made within 90 days of a separation from service generally will be treated as a specified payment date, and for purposes of the subsequent deferral rules the date of the separation from service will be treated as the scheduled payment date.

B. Specified time or fixed schedule of payments

1. In general

The final regulations generally adopt the rules defining a specified time or fixed schedule of payments, including the ability to designate a service provider's taxable year as the year of payment rather than a specific date. For example, a plan provision providing for payment within the service provider's taxable year that includes December 31, 2008, would be treated as a fixed date of payment.

2. Reimbursement and in-kind benefit plans

Many commentators requested additional guidance regarding ways in which rights to taxable reimbursements or in-kind benefits might be structured to meet the definition of a fixed schedule of payments. In response, the final regulations provide that a right to reimbursements or in-kind benefits will meet the requirement of a fixed time and form of payment if certain requirements are satisfied. For this purpose, a reimbursement plan must provide for the reimbursement of expenses incurred during an objectively prescribed period (including a period beginning or ending based upon a service provider's death), where the amount of reimbursable expenses incurred or in-kind benefits available in one taxable year of the service provider cannot affect the amount of reimbursable expenses or in-kind benefits available in a different taxable year. In

addition, the reimbursement payment must be made by no later than the end of the service provider's taxable year following the taxable year in which the expense is incurred. Such reimbursement or in-kind benefit rights may not be subject to liquidation or exchange for another benefit.

For example, a right to a reimbursement of membership fees incurred for each of three specified and consecutive calendar years by a former employee, where the former employee is entitled to reimbursement of the expenses incurred each year without regard to the expenses incurred in a different year, and where the former employee cannot exchange the right for cash or any other benefit, generally will be treated as providing for a fixed time and form of payment if the plan requires that the reimbursement payment be made by no later than the end of the calendar year following the year in which the expense is incurred. In contrast, a right to reimbursement of membership fees of up to \$30,000 over three years would not meet the requirement of a fixed time and form of payment, because the extent to which the former employee incurred the expense in the first year would affect the amount available for reimbursement in a subsequent year.

This rule applies similarly to the provision of in-kind benefits, such as a right to use a corporate vehicle or aircraft. The final regulations also provide a special rule for arrangements reimbursing medical expenses to permit certain aggregate limits on the benefits provided, such as lifetime maximums.

3. *Payment schedules with fixed or formula payment limitations*

Commentators asked whether payment schedules with fixed or objective formula limitations on the amount that may be paid during any particular period would meet the requirement of a fixed schedule or time and form of payment. Where the fixed or formula limitation is established on or before the date the time and form of payment is otherwise required to be set, the fixed or formula limitation is based on a fixed or nondiscretionary, objectively determinable formula limitation on the amount that may be paid in a particular period where all the factors relevant to the determination of such limit are beyond

the control of the service provider and not subject to any exercise of discretion by the service recipient, and the plan specifies the time and form of payment of any additional amount due in excess of the fixed or formula limitation amount, the schedule will be deemed to be a fixed schedule of payments because it is not subject to manipulation. However, a change in the limits or a change in the allocation method for the payment of the unpaid excess amounts that will be paid after the original due dates due to application of the limit may constitute a subsequent deferral election or the acceleration of a payment. Similarly, where the total amount payable under a plan with multiple participants is limited, the time and form of payment requirement may be met if the plan specifies, from the date the time and form of payment is otherwise required to be set, the following: (1) a fixed or nondiscretionary, objectively determinable limit on the amount that may be paid in a particular period such that none of the factors relevant to the determination of such limit is in the control of the service provider or subject to the exercise of any discretion by the service recipient; (2) where there is an overall limitation on the aggregate amount that may be paid to a group of service providers during a specified period, a nondiscretionary, objectively determinable method to allocate the payments that can be made in accordance with the limitation among the service providers participating in the plan over which neither the service recipient nor any service provider retains control or discretion; and (3) the time and form of payment of any amount that will be paid after its original due date because of the formula limitation.

For example, a plan may provide that all payments to all participants under the plan in a given year may not exceed \$1 million, provided that the plan must provide an objective, nondiscretionary method of currently allocating the \$1 million of payments if the amounts otherwise payable exceed \$1 million (such as proportionately to each participant based on the amount otherwise payable to such participant absent the limit), and specifies the time and form of payment of any amount not paid currently because of the limitation (such as at the earliest time possible without exceeding the applicable limitation for any subsequent year). However, a change in

the limits or a change in the allocation method may constitute a subsequent deferral election or an acceleration of a payment.

Commentators also asked whether the same analysis would apply where the limit on a payment is calculated pursuant to a formula related to business performance, such as a specified percentage of cash flow for the period. A payment schedule may be conditioned on a formula limitation if the formula limitation is specified at the time the schedule of payments is otherwise required to be set, the limitation is nondiscretionary and objectively determinable based on the business performance of the service recipient, and the service provider retains no control over the determination or application of the formula limitation. For this purpose, a formula limitation based on profits or other *indicia* of general business performance is not treated as discretionary or in the control of the service recipient. Thus, a plan providing that the maximum payment during a year will equal no more than a set percentage of the service recipient's cash flow for the previous year generally would meet the requirement of a fixed time and form of payment. However, a change in the formula limitation may constitute a subsequent deferral election or an acceleration of a payment. For a discussion of schedules of payments based upon the timing of payments received by the service recipient, see section VII.B.6 of this preamble.

4. *Tax gross-up payments*

Commentators requested clarification of how section 409A applies to a right to a tax gross-up payment that provides the service provider with the right to a payment of taxes otherwise payable by the service provider as well as any additional taxes resulting from the service recipient's payment of the taxes. The final regulations provide that a right to a tax gross-up payment is a right to deferred compensation that satisfies the requirement of a fixed time and form of payment if the plan provides that the tax gross up payment will be made, and the payment is made, by the end of the service provider's taxable year next following the service provider's taxable year in which the related taxes are remitted to the taxing authority.

In addition, the final regulations provide that a right to the reimbursement of expenses incurred due to a tax audit or litigation, whether Federal, state, local, or foreign, satisfies the requirement of a fixed time and form of payment if the right to the reimbursement provides that payment will be made, and the payment is made, by the later of the end of the service provider's taxable year next following the year in which the taxes that are the subject of the audit or litigation are remitted to the taxing authority, or, if no taxes are to be remitted, the end of the service provider's taxable year next following the year in which the audit or litigation is completed. Nothing in the provisions relating to tax gross-up payments modifies the application of section 409A to any underlying compensation arrangement that results in the taxes that are subject to the tax gross-up arrangement.

5. *Payment schedules based on payments to the service recipient*

Commentators requested guidance on payment schedules contingent on the receipt of certain payments by the service recipient. For example, commentators requested clarification whether a plan requiring an annual payment equal to a percentage of certain accounts receivable collected during the prior 12-month period would qualify as a fixed time and form of payment. The ability to schedule payments based upon the time the service recipient receives a customer's payment raises issues regarding the ability to, in effect, create an impermissible event-based payment through characterizing the payment as a schedule (for example, a payment "schedule" that pays an amount every year if a specified transaction occurs in that year actually pays based on whether and when the transaction occurs, which is not a permissible payment event under section 409A). In addition, these arrangements raise issues regarding the ability of the service recipient (or service provider) to control the timing of the payment of deferred compensation through an ability to influence the timing of the payment by the customer. Accordingly, the final regulations generally provide that a schedule based upon the timing of payments to the service recipient is not a fixed schedule of payments. However, the final regulations also provide certain

parameters under which such a plan may qualify as having a fixed time and form of payment. First, if the service recipient is comprised of more than one entity, the payments must be due from a person that is not one of such entities (for example, not a payment due from a subsidiary corporation to a parent corporation). Second, the payments must stem from *bona fide* and routine transactions in the ordinary course of business of the service recipient, and the service provider must not at the time such payments are due retain effective control over the service recipient, the person from whom the payments to the service recipient are due, or the collection of the payments. Third, the payment schedule must provide for a nondiscretionary, objective method of identifying the customer payments to the service recipient from which the amount of the payment is determined, and a nondiscretionary, objective schedule under which payments of the nonqualified deferred compensation will be made (for example, a payment every March 1 of 10 percent of the accounts receivable collected during the previous calendar year). Finally, the sales to which the payment relates must be of a type that the service recipient is in the trade or business of making and makes frequently, and either all such sales must be taken into account or there must be a legitimate, nontax business purpose for limiting the sales taken into account.

C. *Separation from service*

1. *In general*

The final regulations generally adopt the provisions in the proposed regulations defining the circumstances under which a separation from service is deemed to occur, subject to the modifications described in this preamble. Some commentators requested that the parties to a nonqualified deferred compensation plan be permitted to define when a separation from service occurs, at least if they apply the definition consistently. The Treasury Department and IRS believe that a definition of separation from service that is objectively determinable, nondiscretionary and predictable, and not subject to negotiations between the parties is necessary to properly implement the legislative intent behind section 409A. The definitions of separation from

service suggested by the commentators do not meet this standard. For example, a plan that defines separation from service as the date a service provider is removed from a payroll would leave to the parties the discretion to determine a payment date by an action that may have little practical significance, especially when compared to the effect on the service provider's deferred compensation amounts. The Treasury Department and the IRS continue to believe that the definition of separation from service should be based upon an objective determination of whether the service provider continues to provide significant services to the service recipient.

2. *Employees*

a. *In general*

The proposed regulations provided that an employee separated from service with the employer if the employee died, retired, or otherwise had a termination of employment with the employer. Whether a termination of employment had occurred would be determined based on the facts and circumstances. The proposed regulations provided that where the facts and circumstances indicated that the employer and the employee did not intend for the employee to provide more than insignificant future services, the employee would be treated as having a separation from service. For this purpose, an employer and employee would not be presumed to have intended only insignificant services be provided if the employee continued providing services at a rate equal to at least 20 percent of the rate of the previous three years. Where an employee continued providing services in another capacity (for example, as an independent contractor), the employee would be deemed not to have a separation from service if the service provider continued providing services at a rate equal to at least 50 percent of the services provided during the previous three years. Different rules were provided for service providers who were not employees.

Commentators criticized this standard in various respects. The proposed regulations applied one presumption where an employee continued providing services as an independent contractor, and another where an employee continued providing

services as an employee. Commentators asked why the same presumptions did not apply regardless of whether the employee purports to continue service (or separate from service) as an employee or purports to continue service (or separate from service) as an independent contractor. Commentators also suggested that the presumptions should be based on the intent of the employer and employee at the time of the purported separation from service (or purported continuation of services), rather than the actual subsequent conduct. Commentators also argued that the employer and employee could be found to have violated section 409A based on subsequent actual conduct, even where the parties had a *bona fide* belief that a separation from service had or had not occurred, but circumstances changed.

In response to these comments, the final regulations provide a simplified standard, applicable whether an employee continues to provide services as an employee or as an independent contractor. The general standard for determining whether the employee has terminated employment is based on whether the facts and circumstances indicate that the service recipient and employee reasonably anticipated either that no further services would be performed after a certain date or that the level of *bona fide* services the employee would perform after such date (whether as an employee or as an independent contractor) would permanently decrease to no more than 20 percent of the average level of *bona fide* services performed over the immediately preceding 36-month period (or the full period in which the employee provided services to the employer (whether as an employee or as an independent contractor) if the employee has been providing services for less than 36 months). For this purpose, periods during which the employee is on an unpaid *bona fide* leave of absence are disregarded (including for purposes of determining the relevant 36-month period), and periods during which the employee is on a paid *bona fide* leave of absence are treated as periods during which the employee provided services at the level at which the employee would have been required to perform services to receive the compensation if not on a *bona fide* leave of absence. Facts and circumstances to be considered in determining whether the

employee and employer reasonably anticipated that the service provider's future services would be permanently reduced to less than 20 percent of the average level of *bona fide* services provided during the previous 36-month period include, but are not limited to, whether the employee continues to be treated as an employee for other purposes (such as continuation of salary and participation in employee benefit programs), whether similarly situated service providers have been treated consistently, and whether the employee is eligible to perform services for, and realistically available to perform services for, other employers in the same line of business.

To assist in applying this standard, certain rebuttable presumptions are provided. An employee generally will be presumed to have separated from service where the level of *bona fide* services performed (whether as an employee or an independent contractor) changes to a level equal to 20 percent or less of the average level of services provided during the previous 36 months (whether as an employee or an independent contractor). An employee will be presumed not to have separated from service where the level of *bona fide* services rendered continues at a level that is 50 percent or more of the average level of services provided during the previous 36 months. No presumption applies to a change to a level of services between 20 percent and 50 percent of the average level of services provided during the previous 36 months. For purposes of the presumption, the entire period during which the employee has provided services to the employer is substituted for 36 months if the employee has been providing services to the employer for less than 36 months, and periods during which the employee is on a *bona fide* leave of absence are treated in the same manner as such periods are treated for the general rule.

The presumptions are rebuttable, by demonstrating that the employer and the employee reasonably anticipated that as of a certain date the level of *bona fide* services would be reduced permanently to a level less than or equal to 20 percent of the average level of services provided during the immediately preceding 36-month period or full period in which the employee has provided services if the employee has been providing services to the employer

for a period of less than 36 months (or that the level of *bona fide* services would not be so reduced). For example, an employee may demonstrate that the service recipient and employee anticipated that the employee would cease providing services, but that (subsequent to the original cessation of services) business circumstances such as termination of the employee's replacement caused the employee to return to employment. Although the employee's return to employment may cause the employee to be presumed to have continued in employment because the rehired employee is providing services at a rate equal to the rate at which he was providing services before the termination of employment, the facts and circumstances in this case would demonstrate that at the time the employee terminated employment, the employee and the service recipient reasonably anticipated that the employee would not provide any services in the future.

Similarly, where the loss of a business client of the employer results in a permanent reduction in the level of *bona fide* services performed by the employee of more than 80 percent, so that the employee would be presumed to have separated from service, the taxpayer may rebut the presumption that a separation from service occurred by showing that the employer and employee reasonably anticipated that the level of services would not be so reduced. The separation from service would then be deemed to occur at the time that the employer and employee reasonably anticipated that such reduction would continue.

Commentators requested additional flexibility to treat certain employees as having experienced a separation from service, even where the employee continues to provide services in a reduced capacity. This is often referred to as a phased retirement, in which an employee obtains retirement benefits despite continuing to provide services on a part-time or reduced basis. The Treasury Department and the IRS believe that providing flexibility to alter the definition of a separation from service after an amount has been deferred is inconsistent with the statute and legislative intent, and could be subject to manipulation.

However, the final regulations permit certain flexibility for a plan to define a separation from service as including a change to a reduced level of *bona fide* services, if

the definition is specified no later than the time and form of payment are elected or otherwise specified. Specifically, the final regulations provide that rather than treating a separation from service as requiring an anticipated permanent reduction in the level of *bona fide* services to 20 percent or less of the average level of *bona fide* services provided in the immediately preceding 36 months, a plan may treat another level of anticipated permanent reduction in the level of *bona fide* services as a separation from service, provided that the level of permanent reduction required must be set forth in the plan as a specific percentage, and the anticipated permanently reduced level of *bona fide* services must be greater than 20 percent but less than 50 percent of the average level of *bona fide* services provided in the immediately preceding 36 months. The plan must specify the definition of separation from service on or before the date at which a separation from service is designated as a time of payment of an amount deferred, and once designated, any change to the definition of separation from service with respect to such amount deferred will be subject to the rules regarding subsequent deferrals and the acceleration of payments.

For example, on or before the time at which a plan must designate a time and form of payment for a deferred amount, the plan may specify that a separation from service will be deemed to occur at any time that the employee and employer reasonably anticipate that the *bona fide* level of services the employee will perform (whether as an employee or an independent contractor) will be permanently reduced to a level that is less than 50 percent of the average level of *bona fide* services the employee performed during the immediately preceding 36 months (or the entire period the employee has provided services if the employee has been providing services to the employer less than 36 months).

b. Identification of the service recipient

Commentators requested that the definition of the term service recipient be expanded for purposes of determining whether a separation from service has occurred. The final regulations generally adopt this suggestion, so that for purposes of determining whether a service

provider has separated from service with an employer or other service recipient, the service recipient is defined as including all entities that would be treated as part of the group of entities comprising the service recipient under section 414(b) and (c) and the accompanying regulations, but substituting a 50 percent ownership level for the 80 percent ownership level in section 414(b) and (c) and the accompanying regulations. A plan may specify that a higher or lower percentage ownership level will be used, provided that the ownership level may not be higher than 80 percent or lower than 20 percent, and provided further that an ownership level of less than 50 percent may be used only where such use is based on legitimate business criteria. As discussed, the plan must specify the percentage on or before the date at which a separation from service is designated as a time of payment of the amount deferred, and where a plan changes the definition of separation from service with respect to amounts previously deferred, such a change will be subject to the rules governing changes to the time and form of payment, including the anti-acceleration provisions.

Commentators also requested special treatment with respect to the identification of the service recipient in instances where an amount is deferred pursuant to a *bona fide* collective bargaining agreement covering service with multiple employers, and the employee may be expected to perform services covered by the *bona fide* collective bargaining agreement for a number of different employers. Specifically, commentators expressed concern that an employee not be treated as having separated from service when a particular period of service with an employer is completed, if the employee has made herself available to perform services covered by the *bona fide* collective bargaining agreement for another employer. The final regulations generally provide that where the amount is deferred pursuant to a plan provided under a *bona fide* collective bargaining agreement covering services with multiple employers, and where service providers may reasonably anticipate providing services for more than one of the participating employers, the plan may define a separation from service in a manner that treats the service provider as not having separated from service when the

service provider stops performing services for one employer covered by the agreement and provides services for another employer covered by the agreement. The final regulations also provide that the plan may not treat a service provider as having separated from service during periods where the service provider is not providing services but has made herself available to perform services for a participating employer, provided that the definition requires that the service provider be deemed to have separated from service no later than the end of any 12-month period in which the service provider has not provided services covered by the *bona fide* collective bargaining agreement to any employer.

c. *Bona fide* leave

Many of the comments with respect to the definition of separation from service for an employee concerned the treatment of *bona fide* leaves of absence. For purposes of determining whether a service provider has separated from service (and not for purposes of determining whether a vacation or sick leave plan is a *bona fide* vacation or sick leave plan), a *bona fide* leave of absence refers to a leave of absence where there is a reasonable expectation the service provider will return to service with the service recipient. The final regulations provide that an employment relationship is treated as continuing while the individual is on sick leave, or other *bona fide* leave of absence, if the period of such leave does not exceed six months, or if longer, so long as the individual retains a right to reemployment with the service recipient under an applicable statute or by contract. For example, where a tenured professor takes a leave of absence, but the professor retains a right to reemployment with the university as part of the professor's tenured status, the professor will not be deemed to have terminated from employment merely due to the leave of absence from the university. If the period of leave exceeds six months and the individual does not retain a right to reemployment under an applicable statute or by contract, the employment relationship is deemed to terminate on the first date immediately following such six-month period. However, the final regulations modify the provisions in the proposed regulations with respect to

disability leave. With respect to disability leave, the employment relationship will be treated as continuing for a period of up to 29 months, unless otherwise terminated by the employer or the employee, regardless of whether the employee retains a contractual right to reemployment. For this purpose, disability leave refers to leave due to the employee's inability to perform the duties of his or her position of employment or any substantially similar position of employment by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than six months.

d. *Salary continuation programs and terminal leave*

Commentators requested that salary continuation programs be permitted to delay the occurrence of a separation from service, where an employee continues to receive salary and benefits and is otherwise treated as an employee, although not required to perform any further meaningful services. Some commentators also requested this treatment for terminal leave, or leave intended to bridge a service provider to a separation from service date that would permit continuation of benefits or accrual of additional benefits under, for example, a qualified plan. The Treasury Department and the IRS believe that these types of actions are subject to manipulation and should not delay the time when a service provider is treated as having separated from service for purposes of section 409A. Accordingly, the final regulations do not recognize extensions of leave or salary and benefits as a means of delaying the date of separation from service for purposes of section 409A. In addition, terminal leave with no intent to return generally would not be treated as *bona fide* leave for purposes of the rule for employees addressing *bona fide* leave.

Commentators expressed concern that the service recipient may wish to continue providing certain employee benefits, including in-kind benefits and reimbursement plans, during a salary continuation or terminal leave period. With respect to the application of section 409A, such plans generally may be structured to avoid providing for the deferral of compensation, or to provide deferred compensation in com-

pliance with the requirements of section 409A. See sections III.J.6 and VII.B.2 of this preamble. The definition of separation from service for purposes of section 409A is not applicable for purposes of other Code provisions, such as those provisions governing qualified retirement plans or non-taxable benefits.

e. *Rehires and suspensions of benefits*

Commentators also requested that the regulations address rehires, and specifically whether payments of deferred compensation could be suspended during a subsequent period of employment or other service until a subsequent separation from service. Such a suspension generally would violate the rules governing changes in the time and form of payment because payments would be delayed in a manner that does not satisfy the rules applicable to subsequent deferral elections. Neither the statutory language of section 409A nor the legislative history indicates any intent to permit such additional flexibility. Moreover, the Treasury Department and the IRS believe that suspension of benefits rules would add significant complexity to the administration of the Code section. However, many of the desired results of a suspension of benefits provision often may be obtained through deferrals of future compensation after rehire.

f. *Mergers and acquisitions*

Comments with respect to the application of the separation from service standard in the case of a merger or acquisition generally focused on two areas. First, commentators requested that the final regulations adopt permissive use of the rule generally referred to as the "same desk" rule, allowing the parties to an asset purchase agreement to decide whether employees of the selling corporation that continue in the same position with the purchaser of the assets will be treated as separating from service. The final regulations adopt a rule providing that where as part of a sale of assets by one service recipient (seller) to an unrelated service recipient (buyer), a service provider of the seller would otherwise experience a separation from service with the seller, the seller and the buyer may specify whether a service provider providing services to the seller immediately before the asset pur-

chase transaction and providing services to the buyer after and in connection with the asset purchase transaction has experienced a separation from service, provided that the asset purchase transaction results from *bona fide*, arm's length negotiations, all service providers providing services to the seller immediately before the asset purchase transaction and providing services to the buyer after and in connection with the asset purchase transaction are treated consistently (regardless of position at the seller) for purposes of applying the provisions of any nonqualified deferred compensation plan, and such treatment is specified no later than the closing date of the asset purchase transaction. For this purpose, a sale of assets refers to a transfer of substantial assets, such as a plant or division or substantially all of the assets of a trade or business.

Second, commentators requested clarification whether a spin-off of a subsidiary could result in a separation from service of an employee of the subsidiary, where the nonqualified deferred compensation plan defines a separation from service as including any action resulting in the employee no longer being an employee of the controlled group of corporations including the parent corporation. Generally such a transaction would not result in a termination of employment for an employee of the subsidiary, because the employee is continuing employment with the same employer both before and after the transaction. However, the rules that provide a service recipient discretion to terminate and liquidate a plan following a change in control transaction afford taxpayers the flexibility to pay out their deferred compensation liabilities in particular circumstances. See section VIII.B of this preamble.

3. *Directors*

The final regulations provide generally that where a service provider provides services to a service recipient both as an employee and as an independent contractor, the service provider must separate from service both as an employee and as an independent contractor to be treated as having separated from service. But where a service provider provides services both as an employee and a member of the board of directors of a corporate service recipient, the services provided as a director

are not taken into account for purposes of determining whether the service provider has a separation from service as an employee for purposes of a nonqualified deferred compensation plan in which the service provider participates in his or her capacity as an employee that is not aggregated with any plan in which the service provider participates as a director. Accordingly, where an employee-director participates in a separate plan as an employee, his or her termination of services as an employee will constitute a separation from service for purposes of the employee plan, regardless of whether he or she continues providing services as a director (and *vice versa*). However, if a non-employee director is also providing additional services as an independent contractor, he or she cannot have a separation from service for purposes of section 409A until he or she has separated from service both as a director and as an independent contractor.

4. Delay for specified employees

Section 409A(a)(2)(B) provides that with respect to a specified employee, a payment of nonqualified deferred compensation on account of separation from service may not occur before the date that is six months after the date of separation from service (or, if earlier, the date of death of the employee). For this purpose, a specified employee is a key employee of a corporation any stock of which is publicly traded on an established securities market or otherwise. With respect to identifying specified employees, the final regulations generally adopt the provisions set forth in the proposed regulations, subject to the modifications and clarifications described in this preamble.

a. Identification of specified employees

Several commentators asked whether an employee may be subject to the six-month delay requirement if the service recipient stock is publicly traded only on a foreign exchange or is traded on a U.S. exchange only as American depositary receipts or American depositary shares (ADRs). The final regulations define an established securities market for purposes of the six-month delay rule by reference to the rules in §1.897-1(m), which generally include foreign securities markets. Accordingly, the six-month delay may apply

to an employee of a service recipient the stock of which is publicly traded solely on a foreign exchange, or is traded on a U.S. exchange only as ADRs. In the case of a service recipient comprised of multiple entities, this rule would apply if one of the entities had stock that was publicly traded on a foreign exchange.

Some commentators requested that the final regulations provide that specified employees are limited to common law employees, and do not include other individuals. Section 409A(a)(2)(B) defines a specified employee as a key employee as defined in section 416(i) (without regard to section 416(i)(5)). Accordingly, where an individual is treated as a key employee for purposes of section 416(i), that individual generally is a specified employee for purposes of section 409A.

Commentators requested clarification of how the definition of compensation under section 415 applies for purposes of identifying the key employees that may ultimately be specified employees. The final regulations clarify that the general definition of compensation under §1.415(c)-2(a), applied as if the service recipient were not using any safe harbor provided in §1.415(c)-2(d), any of the special timing rules provided in §1.415(c)-2(e), or any of the special rules provided in §1.415(c)-2(g), will be treated as the general definition of compensation for purposes of identifying specified employees. However, the final regulations also provide that a service recipient may use any available definition of compensation under section 415 and the accompanying regulations, including any available safe harbor and any available election under the timing rules or special rules, provided that the definition is applied consistently to all employees of the service recipient for purposes of identifying specified employees. A service recipient may elect to use such a definition of compensation regardless of whether another definition of compensation is being used for purposes of a qualified plan sponsored by the service recipient. However, once a list of specified employees has become effective, the service recipient cannot change the definition of compensation for purposes of identifying specified employees for the period with respect to which such list is effective. For a discussion of the methods for making an election regarding

the definition of compensation, see section VII.C.4.e of this preamble.

Commentators requested clarification of the treatment of the compensation of certain nonresident alien employees. As discussed in the preceding paragraph, for purposes of identifying key employees, the general definition of compensation under §1.415(c)-2(a) applies. A service recipient may elect to apply the rule of §1.415-2(g)(5)(ii) and not treat as compensation certain compensation excludible from an employee's gross income on account of the location of the services or the identity of the employer that is not effectively connected with the conduct of a trade or business within the United States. If no such election is made, the provisions of §1.415(c)-2(g)(5)(i) would apply, requiring the treatment as compensation of certain compensation excludible from an employee's gross income due to the location of the services or the identity of the service recipient.

b. Alternative methods for applying the six-month delay requirement

Commentators expressed concern that an attempt to identify key employees could result in an underinclusive list. Rather than risk a violation, commentators suggested that service recipients be permitted to use an alternative method for determining employees subject to the six-month delay requirement, even where such alternative method may result in an over-inclusive list. A nonqualified deferred compensation plan may provide that all payments upon separation from service will commence six months after the separation from service, regardless of whether the service provider is a specified employee. In addition, the final regulations provide that a plan may use an alternative method identifying the service providers whose distributions will be subject to a six-month delay, provided that the alternative method is reasonably designed to include all specified employees, the alternative method is an objectively determinable standard providing no direct or indirect election to any service provider regarding the application of the rule, and the alternative method results in no more than 200 service providers being identified in the class as of any date. Use of such an alternative method to delay a payment in accordance with the rules

governing the delay of payments to a specified employee will not be treated as a change in the time and form of payment for purposes of the subsequent deferral rules even if the service provider is not a specified employee when the payment is delayed. However, if the list fails to include any individual who is a specified employee and that individual has a right to a payment of deferred compensation upon a separation from service without the required six-month delay, the plan providing such right to such individual will not be in compliance with section 409A. For a discussion of the method of initiating an alternative method designation, see section VII.C.4.e of this preamble.

c. Specified employee effective date issues

Under the proposed regulations, the employees identified as of an identification date would become specified employees effective as of the first day of the fourth month following the identification date. Commentators stated that service recipients who could compile the list of specified employees more quickly should be permitted to make the list effective at an earlier date. The final regulations provide that the first day of the fourth month will be the specified employee effective date if the service recipient does not specify another date. However, the final regulations permit a service recipient to specify a specified employee effective date following the specified employee identification date upon which the new list of specified employees will become effective, provided that the specified employee effective date may not be later than the first day of the fourth month following the specified employee identification date. For example, an employer that designates December 31 as a specified employee identification date for purposes of identifying key employees for purposes of the six-month delay rule, may specify any subsequent date on or before the following April 1 as the first date of the 12-month period during which such list of key employees will be treated as specified employees. To prevent manipulation, any change to the specified employee effective date may not become applicable until 12 months following the change in such specified employee effective date.

The final regulations also clarify that the six-month delay requirement applies only where the service provider is a specified employee as of the date of separation from service, and does not become applicable if the service provider is not a specified employee as of the date of separation from service even if the service provider subsequently would have become a specified employee if the separation had not occurred.

d. Corporate transactions

In response to comments, the final regulations significantly alter the proposed rules governing the identification of specified employees following a corporate transaction, such as a merger or spin-off. Commentators requested clarification of the determination of the next applicable specified employee identification date following the corporate transaction. In addition, commentators generally objected to any rule that resulted in the treatment of more than 50 employees as specified employees due to a corporate transaction (in addition to 1-percent and 5-percent owners treated as specified employees). The final regulations generally permit service recipients to avoid this result, but also permit service recipients to simply combine the pre-transaction separate lists of specified employees where it is determined that such treatment would be administratively less burdensome. Service recipients can determine whether to combine such lists on a case-by-case basis, if there are multiple transactions during the same year.

With respect to mergers and acquisitions, the final regulations address combinations of two public corporations, and combinations of a public and a closely-held corporation. For purposes of the discussion of the rules regarding the treatment of the identification of specified employees following such a transaction, references to specified employees include specified employees determined under any permissible method that the entities participating in the transaction used immediately before the transaction. Where two public corporations merge and become one public corporation, or a public corporation becomes a subsidiary of another public corporation, the final regulations provide that the resulting service recipient's next specified employee identification date and

the first specified employee effective date following the transaction is the specified employee identification date and specified employee effective date that the acquiring service recipient would have been required to use absent the merger. For the period after the date of the transaction and before the next specified employee effective date, the specified employee list of the resulting service recipient consists of the 50 most highly compensated service providers appearing on the combined lists of the two service recipients' specified employees in effect as of the date of the transaction, ranking such specified employees in order of the amount of compensation used to determine each specified employees' status as a specified employee, plus any 1-percent and 5-percent owners not otherwise included who would be treated as specified employees. Alternatively, however, the resulting service recipient may use any other reasonable method to determine its specified employees immediately after the transaction, provided that such method is adopted not later than 90 days after the merger and applied prospectively from the date of adoption. For a discussion of the procedures for adopting such a method, see section VII.C.4.e of this preamble.

Where a public corporation and a private corporation merge and become a public corporation, or where a private corporation becomes a subsidiary of a public corporation, the resulting service recipient's next specified employee identification date and specified employee effective date following the transaction will be the specified employee identification date and specified employee effective date that the pre-transaction public corporation would have been required to use absent such transaction. For the time period after the transaction and before the next specified employee effective date, the specified employees of the pre-transaction public service recipient immediately before the transaction will continue to be the specified employees of the resulting service recipient, and service providers of the pre-merger private service recipient will not become specified employees until the next specified employee effective date. Consequently, the nonqualified deferred compensation plans in which service providers of the formerly private service recipient participate will not be required to contain a plan term delaying a payment upon separa-

tion from service of such service providers, or to delay such a payment, until the next specified employee effective date.

The final regulations also address spin-off transactions. Where as part of a corporate transaction, a public service recipient becomes two separate public service recipients, the final regulations provide that the next specified employee identification date and specified employee effective date of each of the post-transaction service recipients is the specified employee identification date and specified employee effective date that the pre-transaction service recipient would have been required to use absent such transaction. For the period after the date of the transaction and before the next specified employee effective date, the specified employees of the pre-transaction service recipient immediately before the transaction continue to be the specified employees of the post-transaction service recipients.

The final regulations provide guidance on initial public offerings and other corporate transactions where all or part of a private service recipient becomes one or more public service recipients. In that case, except as discussed in this paragraph, each post-transaction public service recipient will have a December 31 specified employee identification date and an April 1 specified employee date. Alternatively, the new public service recipient may establish a different specified employee identification date and specified employee effective date, provided that the specified employee identification date and specified employee effective date must be established on or before the date of the initial public offering or other corporate transaction.

For the period between the date of the initial public offering or other corporate transaction and the first specified employee effective date, the list of specified employees of each post-transaction public service recipient is comprised of the service providers that at the time of the corporate transaction or public offering would have been classified as specified employees of the former private service recipient, had such service recipient adopted the same specified employee identification date and specified employee effective date as selected by such post-transaction public service recipient, and had such former private service recipient been a public service

recipient as of such specified employee identification date.

e. Alternatives for the identification of specified employees

As discussed in this preamble, the final regulations provide certain default definitions for purposes of identifying specified employees, where the service recipient has not adopted another definition. These default rules include the following provisions: the specified employee identification date is December 31; the specified employee effective date is April 1; the general definition of compensation under §1.415(c)-2(a) will apply (without giving effect to any use of the special timing rules under §1.415(c)-2(e) or of a safe harbor definition of compensation under §1.415(c)-2(d)); and certain rules regarding the identification of specified employees after a merger of public service recipients or an initial public offering or other transaction involving a formerly nonpublic service recipient becoming a public service recipient will apply.

Alternatively, the final regulations also provide that the service recipient may use other permissible rules and definitions, provided that such alternatives become effective only in accordance with the rules and deadlines set forth in the final regulations. In addition, the final regulations permit a service recipient to use an alternative method for purposes of identifying specified employees, with certain limitations, and to make an election under §1.415(c)-2(g)(5)(i) regarding the treatment as compensation of certain compensation excludible from an employee's gross income due to the location of the services or the identity of the employer. For purposes of these rules, a service recipient may use one of these alternatives when all necessary corporate action has been taken to make such alternative binding for purposes of all affected deferred compensation plans in which service providers of the service recipient participate. Accordingly, as a practical matter, the service recipient may find it expedient either to specify the definition of specified employee in all of its nonqualified deferred compensation plans or to retain the discretion in all such plans to make such determinations and take any necessary

corporate action in accordance with each such plan.

f. Application of the six-month delay rule

The final regulations reflect the statutory language that a plan may provide that a payment will be made, notwithstanding the six-month delay, upon the service provider's death. A commentator requested similar treatment for the occurrence of a disability, unforeseeable emergency, or change in control event during the six months following the separation from service. The Treasury Department and the IRS do not believe that the statute permits such flexibility, but rather categorically prohibits any distribution due to a separation from service during the six months following the separation from service except where the service provider dies. Accordingly, where a payment on account of a separation from service has been delayed because the service provider is a specified employee, the payment may not be accelerated due to disability, a change in control event, or an unforeseeable emergency. However, where a payment is made to a specified employee on account of disability, a change in control event, or an unforeseeable emergency (as defined for purposes of section 409A), the payment need not be delayed merely because the specified employee separates from service after incurring the disability or unforeseeable emergency, or after the change in control event.

Commentators further requested that various types of periodic benefit payments be excluded from the six-month delay requirement, even if such payments constitute a payment of deferred compensation. Commentators argued that the requirement to delay such payments would be excessively burdensome and impracticable, given the nature and amount of benefits generally available under such arrangements. The Treasury Department and the IRS are not convinced that periodic payment or reimbursement plans should be excluded from the six-month delay rule; otherwise, deferred compensation could simply be converted to such programs to avoid the delay. However, as clarified in the final regulations, certain plans that provide for reimbursements or in-kind benefits during the six months following a separation from service will not

be treated as nonqualified deferred compensation plans under the rules governing separation pay plans. See section III.J.6 of this preamble.

The final regulations also provide that the required delay of a payment to a specified employee upon a separation of service is not violated where the payment is made before the end of the six-month period due to an acceleration of a payment in compliance with the provisions of the regulations permitting accelerated distributions due to a domestic relations order, to satisfy a Federal, state, local, or foreign ethics law, or to pay certain employment taxes (see section VIII of this preamble).

5. Different times and forms of payment on separation from service under specified circumstances

The final regulations continue to provide that a time and form of payment must be specified with respect to each permissible payment event. Under the proposed regulations, a second time and form of payment could be established for a payment due to a permissible payment event where the distinction was based upon the event occurring before or after a certain date, such as the service provider reaching a certain age. Commentators requested that different times and forms of payment be permitted if based upon different types of separations from service. The final regulations generally provide that the time and form of payment upon a separation from service may vary depending upon either or both of the following: (1) whether the separation from service occurs during a limited period of time not to exceed two years following a change in control event as defined for purposes of section 409A; or (2) whether the separation from service occurs before or after a specified date (for example, the attainment of a specified age), or before or after a combination of a specified date and a specified period of service determined under a predetermined objective formula or pursuant to the method for crediting service under a qualified plan sponsored by the service recipient. The addition or deletion of such a different time and form of payment applicable to an existing deferral is subject to the subsequent deferral election rules and the anti-acceleration rules.

D. Disability

The final regulations generally adopt the definition of disability and other provisions related to the payment of an amount upon a service provider becoming disabled contained in the proposed regulations, subject to the modifications described in this preamble. For this purpose, a participant is disabled if the participant is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, or is, by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than 3 months under an accident and health plan covering employees of the participant's employer. The determination of whether a service provider is disabled may be made by any person, including the administrator of a disability insurance program, and the plan need not specify who will make the determination. However, the plan will be treated as complying with section 409A only if the disability required for a payment complies with the definition of disability under the regulations, and a payment due to a disability will be deemed to comply with section 409A only if the service provider has actually suffered a qualifying disability. The final regulations also provide that a plan may provide that a service provider will be deemed disabled if the service provider is determined to be totally disabled by the Social Security Administration or the Railroad Retirement Board.

Commentators raised questions concerning the ability to pay upon the occurrence of a disability that does not qualify as a disability under the statute, where as a result of the disability the service provider has a separation from service. Such a payment would not constitute a payment due to a disability that complied with section 409A. However, if the plan provided for a payment due to the separation from service, a payment would constitute a payment due to a separation from service regardless of whether the separation from service resulted from such

a disability and regardless of whether the service provider's right to receive such payment was conditioned upon the service provider being disabled under such disability definition.

E. Death

Most of the comments with respect to amounts that are payable due to the death of a service provider related to whether a beneficiary of the service provider could be given the opportunity to elect a time and form of payment under a plan without violating section 409A. The final regulations clarify that elections with respect to the time and form of payment to a beneficiary are subject to the general rules governing subsequent deferrals and accelerated payments, including elections by either the service provider or the beneficiary (with an exception for amounts payable under a domestic relations order). However, a change in a beneficiary will not be treated as a change in the time and form of payment, if the change in the time of payment stems solely from the different life expectancy of the new beneficiary, such as in the case of a joint and survivor annuity. Commentators requested that beneficiaries be permitted a limited period of time in which to change the time and form of payment without being subject to the subsequent deferral and anti-acceleration provisions. The Treasury Department and the IRS do not believe that the statutory language supports this type of late deferral election or payment acceleration. Accordingly, these suggestions are not adopted in the final regulations.

F. Change in ownership or effective control of a corporation

The final regulations generally adopt the provisions contained in the proposed regulations with respect to the definition of a change in control event, as well as certain special rules with respect to payments upon a change in control event, subject to the modifications described in this preamble.

One commentator requested that the threshold for a change in the effective control of a corporation be lowered from 35 percent to 20 percent, especially for a public corporation. The legislative history of section 409A indicates that the definition of a change in control event

is to be based upon, but more restrictive than, the definition provided in section 280G. H.R. Conf. Rep. No. 108-755, at 730 (2004). Given that §1.280G-1, Q&A-28(a)(1) provides for a 20 percent standard, the adoption of that standard is not appropriate in light of the legislative history. However, the final regulations lower the threshold to 30 percent.

One commentator requested guidance with respect to the application of the change in control provisions to non-stock, non-profit corporations. The Treasury Department and the IRS are considering whether such guidance is appropriate, and if so what types of changes could be treated as analogous to a change in control event involving a stock corporation. Until further guidance, a non-stock, non-profit corporation may apply the change in effective control provisions in §1.409A-3(i)(5) (relating to a change in the composition of the board of directors) by analogy to changes in the composition of its board of directors, trustees, or other governing body.

The final regulations continue to provide that in the case of a payment on account of certain change in control events (a change in ownership of a corporation or a change in the ownership of a substantial portion of a corporation's assets), compensation payable pursuant to the service recipient's purchase of service recipient stock or a service recipient stock right held by a service provider, or payment of amounts of deferred compensation calculated by reference to the value of service recipient stock, generally may be treated as complying with the requirements of section 409A if paid under the terms and conditions that govern the payments to shareholders or the service recipient in connection with the change in control event. The final regulations continue to require that such amounts be paid no later than five years after the change in control event. However, the final regulations also provide that where such compensation is made subject to a condition on payment that constitutes a substantial risk of forfeiture under section 409A (without regard to the prohibition on additions or extensions of forfeiture conditions), and such compensation is payable under the same terms and conditions as apply to payments made to shareholders generally with respect to stock of the service recipient, or to

the service recipient itself, pursuant to the change in control event, for purposes of determining whether such compensation is a short-term deferral the requirements of the short-term deferral rule are applied as if the legally binding right to such compensation arose on the date that it became subject to the substantial risk of forfeiture. The regulations also provide rules under which certain pre-existing forfeiture conditions may be extended or modified in connection with such a change in control event.

G. Unforeseeable emergency

The final regulations apply the provisions set forth in section 409A(a)(2)(B)(ii) regarding payments upon an unforeseeable emergency. The final regulations provide that a distribution on account of unforeseeable emergency may not be made to the extent that such emergency is or may be relieved through reimbursement or compensation from insurance or otherwise, by liquidation of the service provider's assets, to the extent the liquidation of such assets would not cause severe financial hardship, or by cessation of deferrals under the plan. The final regulations clarify that for these purposes, the availability of payments under any qualified plan (including any assets available by obtaining a loan under a qualified plan), or under any other non-qualified deferred compensation plan due to the unforeseeable emergency, including plans that would be nonqualified deferred compensation plans for purposes of section 409A except due to the effective date of the statute, need not be considered in determining whether an emergency is or may be relieved through other means. Accordingly, a payment due to an unforeseeable emergency may be made pursuant to a non-qualified deferred compensation plan that is subject to section 409A even though the financial need could be satisfied through an available distribution or loan from a qualified plan, or from another nonqualified deferred compensation plan (including a grandfathered plan) due to the unforeseeable emergency.

Section 826 of the Pension Protection Act of 2006, Public Law 109-280 (120 Stat. 780) modified the rules governing payments upon an unforeseeable emergency. Specifically, section 826 requires that the Treasury Department and the IRS

modify the rules for determining whether a service provider has had an unforeseeable emergency for purposes of section 409A(a)(2)(B)(ii) to provide that if an event would constitute a hardship under the plan if it occurred with respect to the service provider's spouse or dependent, such event will, to the extent permitted under a plan, constitute a hardship if it occurs with respect to a person who is a beneficiary under the plan with respect to the service provider. The final regulations reflect this modification.

H. Multiple payment events

The final regulations provide that a plan may provide for a payment based upon the earlier of, or the later of, a series of events, provided that each payment event would otherwise satisfy the requirements of section 409A. The final regulations also provide that for purposes of the subsequent deferral and acceleration rules, each payment event will be viewed separately for purposes of analyzing the effect of a change in the time and form of payment. For a discussion of the effect of the addition or deletion of a permissible payment event from such a list, see section IX.C of this preamble.

I. Delay in payment by the service recipient

Commentators requested that a service recipient be permitted to delay a payment, where the delay is due to *bona fide* business concerns such as cash flow considerations. Where a payment is delayed due to the operation of a pre-specified objective, nondiscretionary formula related to the business performance of the service recipient, the payment generally may be delayed (for example, where payments in any given year are limited to a certain percentage of cash flow) provided that the time for later payment is governed by the objective, nondiscretionary formula. See section VII.B.3 of this preamble. In addition, the final regulations provide that if at the time of a specified payment date the making of the payment would jeopardize the ability of the service recipient to continue as a going concern, the payment will be treated as made upon the specified payment date if the payment is made during the first taxable year of the service

provider in which the making of the payment would not have such effect. This provision is not required to be explicitly provided in the plan.

Because this provision permits the service recipient to delay any payment the making of which would jeopardize the ability of the service recipient to continue as a going concern, the provision in the proposed regulations permitting a delay in payment required to avoid a violation of a loan covenant or similar contractual obligation, where such violation would cause material harm to the service recipient, has not been adopted in the final regulations. Rather, where the payment would result in a violation of a loan covenant or similar contractual obligation, and the violation would jeopardize the ability of the service recipient to continue as a going concern, the payment can be delayed under the general provision.

The final regulations adopt the provision of the proposed regulations that permits a delay in payment necessary to avoid the application of the deduction limitation under section 162(m), subject to the following modifications. First, a plan is not required to provide explicitly for such a delay. However, the final regulations require that where any payment in a service recipient's taxable year is delayed in accordance with this provision, then all payments that could be delayed in accordance with this provision must be delayed (though some payments may be delayed until after separation from service and others until the earliest taxable year in which the deduction limitation no longer applies). Second, except as provided in the next sentence, the regulations provide that the payment must be made either during the service provider's first taxable year in which the service recipient reasonably anticipates, or reasonably should anticipate, that if the service recipient makes such payment during such year such payment will not fail to be deductible because of section 162(m) or, if later, during the period beginning on the day the service provider separates from service and ending on the later of the last day of the service provider's taxable year in which the separation from service occurs or the 15th day of the third month following the separation from service. Finally, the final regulations provide that where the payment has been delayed until the service provider's sepa-

ration from service, the six-month delay requirement for specified employees may apply. Although commentators argued that the six-month delay rule should not apply because the original payment would not have been subject to the rule, this same argument could be made with respect to any deferral election to have current compensation paid instead at a separation from service, and accordingly is not adopted in the final regulations.

J. *Disputed payments and refusals to pay*

The final regulations adopt the provisions in the proposed regulations with respect to disputed payments and refusals to pay, subject to certain modifications. If a payment is not made due to a service recipient's refusal to pay an amount, the amount generally will be treated as paid in a timely manner if the service provider makes reasonable, good faith efforts to collect the payment. This provision is intended to address not only intentional refusals to pay, but also inadvertent delays (but, in either case, only if there is no collusion between the service provider and service recipient). For example, where through oversight a service recipient fails to make a payment on the required payment date, the payment will be treated as made on the specified date if the service provider makes reasonable, good faith efforts to collect the payment, generally through providing timely notice to the service recipient that the payment is due and unpaid. For this purpose, efforts to collect the payment will be presumed not to be reasonable, good faith efforts if notice is not given to the service recipient within 90 days of the latest date upon which the payment could have been timely made in accordance with the terms of the plan and the regulations and, if not paid, further measures to enforce the payment are not taken within 180 days after such date. For a discussion of payments that are accelerated due to a settlement of a *bona fide* dispute as to the service provider's right to the payment, see section VIII.G of this preamble.

K. *Back-to-back arrangements*

The proposed regulations addressed certain arrangements under which an entity (the intermediate service recipient) receives services from a service provider and provides services to a client (the ulti-

mate service recipient), and the time the intermediate service recipient is entitled to receive a payment for services rendered to the ultimate service recipient is controlled by the date on which the intermediate service recipient is obligated to make a payment of deferred compensation to the service provider. For example, assume an intermediate service recipient provides investment management services for a group of investors. Pursuant to a nonqualified deferred compensation plan, the intermediate service recipient has agreed to pay its employee a sum certain when the employee terminates employment. Under the intermediate service recipient's agreement with the investor group, the investors will pay the same sum certain to the intermediate service recipient when the employee terminates employment. The proposed regulations referred to these types of arrangements as back-to-back arrangements.

The final regulations adopt the proposed provisions that addressed back-to-back nonqualified deferred compensation arrangements, subject to the modifications described in this section. The final regulations clarify that the rules addressing back-to-back arrangements apply regardless of whether the arrangement between the service provider and the intermediate service recipient is actually subject to section 409A, as long as each arrangement that is part of the overall back-to-back scheme complies with the requirements of section 409A without regard to whether such arrangement is actually subject to section 409A. Accordingly, the accommodations afforded to back-to-back arrangements are only applicable to the extent that each arrangement satisfies the requirements of section 409A as if those requirements applied to each such arrangement (modified in accordance with the back-to-back rules).

Commentators also requested that, with respect to taxpayers providing management services that are not eligible for the exception from coverage for independent contractors with multiple unrelated customers, the exception from the general payment timing rules permitting certain back-to-back arrangements be expanded to include not only arrangements where the payment from an ultimate service recipient to the intermediate service recipient is based upon the timing of a required payment under a section 409A

compliant plan from the intermediate service recipient to a service provider (a forward back-to-back arrangement), but also where the payment to the service provider is based upon a required payment under a section 409A compliant arrangement from the ultimate service recipient to the intermediate service recipient (a reverse back-to-back arrangement). For example, a service recipient that provides investment management services to an investor group may have an arrangement whereby the investors are required to pay all amounts due to the investment manager service recipient if the investor group terminates the client relationship, and the investment manager service recipient in turn has an agreement with an employee to pay the employee a certain percentage of the amount the investor group pays to the investment manager service recipient, following termination of the client relationship. The final regulations do not provide an exception from the requirements of section 409A for reverse back-to-back arrangements, but the Treasury Department and the IRS will continue to study the matter.

VIII. *Prohibition of Accelerated Payments*

A. *In general*

Section 409A(a)(3) provides that a plan may not permit the acceleration of the time or schedule of any payment under the plan, except as provided in regulations by the Secretary. The final regulations retain the provisions in the proposed regulations relating to accelerated payments, subject to the modifications described in this preamble.

The final regulations generally provide that a payment of an amount as a substitute for a payment of deferred compensation will be treated as a payment of the deferred compensation, including for purposes of the prohibition on accelerated payments. Where a payment of an amount results in an actual or potential reduction of, or an actual or potential current or future offset to, an amount of deferred compensation, or the service provider receives a loan the repayment of which is secured by or may be accomplished through an offset of a nonqualified deferred compensation benefit, then the payment or loan is a substitute for the deferred compensation and is treated as

a payment of the deferred compensation itself. If a service provider's rights to deferred compensation are subject to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, or garnishment by creditors of the service provider or the service provider's beneficiary, such amounts are treated as having been paid to the service provider.

The receipt of a payment of compensation, or right to a payment of compensation, proximate to the purported forfeiture or voluntary relinquishment of a right to deferred compensation generally is treated as a substituted payment for the payment of the deferred compensation. For example, where the right to an amount of deferred compensation is purportedly relinquished or forfeited, and concurrently or subsequently the service provider receives a current bonus payment, the bonus payment will be presumed to be a substitute payment for the amount of deferred compensation. The presumption is rebuttable by a showing that the compensation paid would have been paid regardless of the relinquishment or forfeiture of the right to the deferred compensation. For a discussion of the application of this provision to amounts forfeitable upon a separation from service, see section III.J.1 of this preamble.

A plan may not provide discretion to a service provider regarding whether a payment will be accelerated under one of the rules permitting the acceleration of payments under specified circumstances (for example, to comply with a domestic relations order), including through the provision of an election. However, where a plan provides a service recipient discretion to accelerate payments under one of the rules permitting the acceleration of a payment, the failure to accelerate such a payment will not constitute a subsequent deferral election.

B. *Plan termination and liquidation*

The proposed regulations contained provisions permitting a service recipient to terminate and liquidate a nonqualified deferred compensation plan, including when the service recipient has declared bankruptcy, when the service recipient has participated in certain change in control events, or at the discretion of the service recipient, all subject to certain re-

strictions and limitations. Commentators expressed concern over the restrictions and limitations. Some comments reflected confusion as to the meaning of these terms in the context of section 409A. The termination and liquidation of a nonqualified deferred compensation plan involves both the amendment of the plan to cease deferrals under the plan and provide for payment of all benefits accrued under the plan, and the accelerated payment of benefits accrued under the plan.

Several comments suggested that the final regulations expand the circumstances under which a service recipient may terminate and liquidate a nonqualified deferred compensation plan. Generally these comments requested discretion in case of a change in business conditions or circumstances, resulting in the service recipient's desire to terminate and liquidate the plan. The final regulations expand the circumstances under which a sale of assets of a corporation will result in a separation from service. See section VII.C.2.f of this preamble. In addition, the final regulations continue to allow the service recipient to terminate and liquidate a plan during a defined period following a change in control event. Outside of these particular business events, the comments failed to provide an objective standard or category of changes in business conditions or circumstances that would provide a safeguard against the use of plan termination and liquidation provisions to circumvent the prohibition on accelerations. Accordingly, the final regulations do not expand the ability of a service recipient to exercise its discretion to terminate and liquidate a deferred compensation plan. However, the period of time during which a service recipient may not commence a new plan after terminating and liquidating a nonqualified deferred compensation plan has been shortened from five years to three years. Also, the final regulations provide that a discretionary plan termination and liquidation will not qualify for this exception if it is proximate to a downturn in the financial health of the service recipient.

The final regulations clarify the rules under which a deferred compensation plan may be terminated and liquidated upon a change in control event. Under the final regulations, the service recipient must, within the 30 days preceding or the 12 months following the change in control

event, take all necessary action to terminate and liquidate the plan and such action must be irrevocable. In addition, for the plan to be treated as terminated and liquidated, all other arrangements that would be classified with the plan as a single plan if the same service provider participated in the plan and all the other arrangements must be terminated and liquidated, so that all service providers who are participants in the plan and all such other arrangements required to be terminated and liquidated must receive all amounts of compensation deferred under the terminated and liquidated plan and other arrangements within 12 months of the date the service recipient takes such irrevocable action to terminate and liquidate the arrangements. For purposes of the rule, the entities comprising the service recipient are determined immediately following the change in control event, and the rule only applies with respect to service providers for whom a change in control has occurred. For example, where the change in control event consists of a sale of a subsidiary corporation such that the subsidiary corporation is no longer treated as a single service recipient with the (former) parent corporation, the requirement to terminate and liquidate substantially similar arrangements applies only to the purchaser service recipient group of corporations that now owns the subsidiary corporation. In addition, the rule would apply only to the service providers that had experienced a change in control, generally consisting only of the service providers of the subsidiary corporation. Where the change in control event consists of an asset purchase, the applicable service recipient with discretion to terminate and liquidate the plan is deemed to be the entity retaining the deferred compensation liability after the transaction.

Some commentators asked whether the plan termination and liquidation rules apply if a plan is terminated and liquidated when the service provider has no vested right to a payment, and all payments are forfeited. Where the service recipient retained the unfettered discretion to terminate such a plan without paying benefits, the service provider may not have obtained a legally binding right to a payment. In addition, if a service provider forfeits benefits under a nonqualified deferred compensation plan in exchange for other taxable benefits, those benefits may be treated as

a payment of amounts under the nonqualified deferred compensation plan.

C. Conflicts of interest and ethics rules

The proposed regulations contained a special accelerated payment rule to permit accelerated payments required to be made by a certificate of divestiture. Notice 2006-64, 2006-29 I.R.B. 88, see §601.601(d)(2), expanded this exception to address situations in which a letter is received from the Office of Government Ethics that divestiture of the deferred compensation is required. Several commentators requested an expansion of these rules.

The final regulations provide that a payment may be accelerated where necessary for a Federal officer or employee in the executive branch to comply with an ethics agreement with the Federal government. The final regulations also provide that a payment may be accelerated where reasonably necessary to avoid the violation of a Federal, state, local, or foreign conflict of interest law or ethics law (including where such payment is reasonably necessary to permit the service provider to participate in activities in the normal course of his or her position in which the service provider would otherwise not be able to participate under an applicable law). For this purpose, a payment will be reasonably necessary to avoid such a violation if the making of the payment is a necessary part of a combination of actions resulting in compliance with the applicable law. A payment may be considered necessary to avoid such a violation even though actions other than making the payment could also result in compliance with the applicable law. For example, as requested by several commentators, this provision would provide a public accounting firm the ability to accelerate payments where reasonably necessary to satisfy conflict of interest rules prescribed by the Securities and Exchange Commission. This paragraph is intended to address payments to service providers, as well as payments to a spouse or minor children where such payments are reasonably necessary to comply with the applicable law. For this purpose, foreign law is considered to be applicable only to foreign earned income from sources within the foreign country that promulgated such law.

D. State and local taxes, RRTA tax and foreign taxes

Commentators stated that certain state and local jurisdictions tax nonqualified deferred compensation plans under a different set of rules than the Federal income tax rules, typically by reference to the rules applicable to FICA taxes. Commentators also requested that accelerations be permitted to cover applicable RRTA taxes. Finally, commentators requested that accelerated payments be permitted to account for the tax laws of foreign jurisdictions that may not be consistent with the Federal income tax rules. The final regulations adopt the suggestions with respect to state and local taxes, RRTA taxes, and foreign taxes.

E. Minimum distributions under section 280H(d)

One commentator suggested that acceleration be permitted to allow a personal service corporation to make minimum distributions to avoid taxation under section 280H(d). The Treasury Department and the IRS believe that such a provision would give taxpayers excessive control over the payment of deferred amounts that would be inconsistent with the purposes of section 409A. Therefore, this suggestion was not adopted.

F. Top hat plan rules

Some commentators requested that the final regulations permit a service recipient to accelerate payments or cancel deferral elections with respect to a service provider who is not part of a select group of management or highly compensated employees for purposes of the exclusion from coverage under certain provisions of the Employee Retirement Income Security Act of 1974 relating to top hat plans. See, for example, 29 U.S.C. §1051(2). Given the current lack of clarity with respect to the scope of coverage of the top hat plan rules, and the actions required when a plan participant no longer satisfies the requirement to qualify for the top hat plan rules, the Treasury Department and the IRS are not confident that an exception to the anti-acceleration provisions based upon these rules is feasible. Accordingly, the final regulations do not adopt this suggestion.

G. Settlements of bona fide disputes regarding the right to a payment

Commentators requested relief for certain payments made as a settlement of a dispute as to a service provider's right to a deferred amount. For example, assume that a plan provides for a payment of deferred compensation upon a termination of an employee's employment other than for cause and the employee and employer have a *bona fide* dispute as to whether the employee was terminated for cause, and thus whether the service provider is entitled to any payment under the plan. The final regulations provide that payments may be accelerated, including acceleration to payment as a lump sum, where the right to such payments arises as part of a settlement between the service provider and the service recipient of a *bona fide* dispute as to the service provider's right to the deferred amount. The provision applies only to a deferred amount, the right to which is the subject of an arm's length settlement of a *bona fide* dispute between the service provider and the service recipient, and only to the portion of the deferred amount that is the subject of the *bona fide* dispute. The provision does not apply to disputes that relate only to when (and not whether) a payment is due. Whether a payment qualifies for the exception is based on the particular facts and circumstances. A payment will be presumed not to meet this exception unless the payment is subject to a substantial reduction in the value of the payment made in relation to the amount that would have been payable had there been no dispute as to the service provider's right to the payment. For this purpose, a reduction that is less than 25 percent of the present value of the deferred amount in dispute generally is not a substantial reduction. In addition, a payment will be presumed not to meet this exception if the payment is made proximate to a downturn in the financial health of the service recipient.

H. Cashout rules

Commentators requested various modifications to the cashout rules generally expanding the conditions under which a service recipient may exercise discretion to cash out a service provider's entire amount deferred under a plan. The final

regulations generally provide that a service recipient may exercise such discretion at any time that a service provider's amount deferred under the plan is less than the applicable dollar amount under section 402(g)(1)(B) for that calendar year. For this purpose, the plan aggregation rules apply, so a service recipient may not use this rule to cash out an amount under one arrangement but not another arrangement where the two arrangements would be treated as one plan. The final regulations, unlike the proposed regulations, do not require that a service provider have separated from service for the service recipient to cash out the amount deferred. In addition, the plan does not need to be amended to provide this discretion to the service recipient. Finally, the amount has been changed from \$10,000 to the limit on elective deferrals under section 402(g) to permit the amount to be adjusted for changes in the cost of living.

The final regulations also provide that a plan under which amounts are to be paid in installments may provide for immediate payment of all remaining installments if the present value of the deferred amount to be paid in the remaining installments falls below a predetermined amount, and such immediate payment will not constitute an accelerated payment for purposes of §1.409A-3(j)(1), provided that such feature (including the predetermined amount) is established no later than the latest time at which the time and form of payment is otherwise required to be established, and provided further that any change in such feature including the predetermined amount must comply with the requirements for a change in the time and form of payment.

I. Other acceleration issues

Commentators requested that a service recipient be permitted to cancel a service provider's deferral elections in two situations. First, commentators asked that such a cancellation be allowed when the service provider is transferred to a position that is not eligible to participate in the plan. The Treasury Department and the IRS are not confident that a standard can be established that would clearly distinguish a *bona fide* transfer to an ineligible position from a *pro forma* transfer designed to avoid the prohibition on ac-

celerated payments, especially when the underlying plan is specific to the service provider, as in the case of an individual employment agreement, and accordingly the final regulations do not adopt this suggestion. Second, commentators asked that a service provider's deferral election be cancelled if the service provider becomes disabled. The final regulations permit the cancellation of the service provider's deferral election due to a disability, provided that for this purpose a disability is defined as any medically determinable physical or mental impairment resulting in the service provider's inability to perform the duties of his or her position or any substantially similar position, where such impairment can be expected to result in death or can be expected to last for a continuous period of not less than six months.

IX. Subsequent Changes in the Time and Form of Payment

A. In general

The final regulations clarify that the rules governing changes in the time and form of payment apply both to service providers and service recipients. Accordingly, a service provider, a service recipient, or both a service provider and a service recipient may have and exercise discretion to defer a deferred compensation payment after the time and form of payment have been specified, provided that such discretion is limited to changes that comply with the requirements of these regulations addressing subsequent changes in the time and form of payment.

B. Annuities

Many commentators requested clarification and expansion of the rules that allow taxpayers to treat actuarially equivalent life annuities as one form of payment, thereby allowing elections among such annuity forms at any time before the initial annuity payment without regard to the rules on subsequent deferral elections. The final regulations clarify the circumstances under which two actuarially equivalent life annuities may be treated as one form of payment.

The final regulations generally provide that certain specified features are ignored for purposes of determining whether a particular annuity is treated as a life annu-

ity for purposes of the form of payment rules (but not for purposes of determining whether a life annuity with such a feature is actuarially equivalent to a life annuity without such a feature). The specified features include: (1) term certain features (under which annuity payments continue for the longer of the life of the annuitant or a fixed period of time); (2) pop-up provisions (under which payments increase upon the death of the beneficiary or another event that eliminates the right to a survivor annuity); (3) cash refund features (under which payment is provided upon the death of the last annuitant in an amount that is not greater than the excess of the present value of the annuity at the annuity starting date over the total of payments before the death of the last annuitant); (4) Social Security or Railroad Retirement leveling features (including leveling features related to early retirement, survivor or disability benefits); and (5) features applying a permissible cost-of-living index. Accordingly, a life annuity with any of the specified features may be treated as a life annuity without regard to the fact that the features cause the annuity to fail to satisfy the general definition for life annuities, for example, because the periodic payments are not substantially equal. However, the life annuity with such a feature may only be treated as the same form of payment as a life annuity without such a feature if the two life annuities are actuarially equivalent (taking into account the feature) and have the same initial payment date.

Commentators also raised issues concerning the availability of subsidized joint and survivor annuities. The final regulations provide that for purposes of the definition of a time and form of payment, a subsidized joint and survivor annuity is treated as actuarially equivalent to a single life annuity provided that, neither the annual lifetime annuity benefit nor the annual survivor benefit available under the joint and survivor annuity is greater than the annual lifetime annuity benefit available under the single life annuity. For example, a single life annuity providing \$100 a month for the lifetime of the service provider may be treated as actuarially equivalent to a joint and survivor annuity providing up to \$100 a month for the lifetime of the service provider and up to \$100 a month to the surviving joint annuitant.

Commentators asked whether the actuarial assumptions and methods used to determine actuarial equivalency must be applied consistently. The final regulations clarify that in determining whether two life annuities are actuarially equivalent, the same actuarial assumptions and methods must be used in valuing each life annuity. This requirement applies over the entire term of the service provider's participation in the plan, such that the annuities must be actuarially equivalent at all times for the annuity options to be treated as one time and form of payment. However, provided the actuarial methods and assumptions are reasonable, there is no requirement that consistent actuarial assumptions and methods be used over the term of the service provider's participation in the plan. Accordingly, the plan may change the actuarial assumptions and methods used to determine the life annuity payments, provided that all of the actuarial assumptions and methods are reasonable. In addition, there is no requirement that the actuarial assumptions and methods used under a nonqualified deferred compensation plan be the same as those used in a qualified plan sponsored by the service recipient.

C. Application to multiple payment events

The final regulations continue to provide that the subsequent deferral and anti-acceleration rules generally will apply to the addition or deletion of a permissible payment event. Commentators asked for clarification of how these rules apply.

The Treasury Department and the IRS believe that a failure to provide for a payment event at death, disability or an unforeseeable emergency generally will result from oversight, and that the addition of such a provision generally would not be abusive. Accordingly, the final regulations provide that the addition of death, disability, or an unforeseeable emergency as a potentially earlier payment event is a permissible acceleration. This provision does not apply to the addition of death, disability, or an unforeseeable emergency as a potentially later payment event, such as through the addition of death as a payment event to a plan providing for a payment of deferred compensation on a fixed date, so that after the change the payment would be due on the later of the fixed date or death. Nor, for example, would it ap-

ply to an amendment of a plan to substitute a service provider's death as a new payment event, instead of a fixed payment date. In those cases, the rules governing subsequent deferral elections apply. In addition, the substitution of death as a payment event for an amount that is deferred compensation will not cause the plan to be treated as a death benefit plan not subject to section 409A, but the substitution or addition of a payment event other than death as a payment event in a death benefit plan may result in the plan being treated as providing for deferred compensation.

The anti-acceleration provisions apply to the addition of a specified date or fixed schedule, a change in control event, or separation from service as a potentially earlier payment event, including the substitution of one of these payment events for another payment event. In addition, the anti-acceleration provisions apply where a payment event is removed from a plan term requiring payment upon the latest of two or more payment events. The provisions governing subsequent deferral elections apply to all changes in the time and form of payment, whether resulting from the addition, deletion or substitution of another payment event. Commentators requested clarification of how this provision would apply where the events were not specified dates, such as the substitution of a change in control payment event for a separation from service event. In such a situation, to satisfy the rules governing subsequent deferrals, this substitution would only be permissible if the change were not effective for one year, and provided that the payment would only occur upon the later of a change in control event or at least five years following a separation from service.

D. Application to domestic relations orders

The final regulations provide that the rules governing changes in the time and form of payment do not apply to changes in the time and form of payment under the terms of a domestic relations order, to the extent the change in the time and form of payment applies to a payment that will be made to the alternate payee and not the service provider. Accordingly, for example, a domestic relations order generally may provide for a new time and form of payment to a spouse or former spouse of the

service provider, or provide such spouse or former spouse discretion to determine the time and form of payment to such spouse or former spouse.

X. Application to nonqualified deferred compensation plans linked to qualified plans and other arrangements

A. Plans linked to qualified plans and certain broad-based foreign retirement plans

The final regulations generally adopt the relief provided in the proposed regulations with respect to the election-timing and the anti-acceleration rules for changes in the amount of benefits under a nonqualified deferred compensation plan that result from an election (or failure to elect) by a service provider, or an amendment by a service recipient, in respect of a subsidized or ancillary benefit under a qualified plan. In response to comments, this relief is similarly extended to certain broad-based foreign retirement plans. In addition, this relief is extended for benefit formulas that include a reduction for amounts credited to the service provider's account under a tax-qualified plan (which may include matching contributions) or certain broad-based foreign retirement plans that provide benefits expressed as an account balance.

In response to comments, the final regulations also clarify that the linked plan relief provided for elective deferrals (including designated Roth contributions) and matching type contributions is subject to two separate, additive limits and not a single, coordinated limit. In addition, the final regulations clarify that the section 402(g) dollar limits are increased by the limit on catch-up contributions under section 414(v) for any year in which the service provider qualifies for such increase.

Commentators raised issues concerning other types of plans under which a service provider must participate in a qualified plan to receive nonqualified deferred compensation. Specifically, commentators asked whether a plan could comply with section 409A if it provided that an employee must defer the maximum amount permissible under a qualified plan in order to defer any amount under a nonqualified deferred compensation plan. Where the service provider can change the service

provider's election to defer the maximum amount permissible under the qualified plan during the taxable year, and thereby change or discontinue deferrals under a nonqualified deferred compensation plan, the service provider can effectively make a late election to defer (or not defer) amounts under the nonqualified plan. The final regulations generally do not provide any additional relief with respect to this type of plan. However, where the additional amounts deferred under the nonqualified deferred compensation plan reflect only matching contributions that would be available under the qualified plan absent the restrictions in the qualified plan intended to reflect limits on qualified plan contributions under sections 401(m) and 401(a)(17), the final regulations provide relief but solely with respect to the matching amount that could have been contributed to the qualified plan absent such limits.

Commentators also stated that the rules in the proposed regulations did not adequately address the impact of after-tax contributions. Specifically, commentators requested relief for service providers who change their after-tax contributions (other than designated Roth contributions) under a qualified plan during a year where such decrease causes a corresponding change in nonqualified plan elective deferrals. The final regulations provide some additional relief concerning matching or other contributions contingent upon the making of an after-tax contribution. However, other suggestions were not adopted in the final regulations, because the Treasury Department and the IRS are concerned that such plans may give the service provider excessive control over amounts deferred under a nonqualified deferred compensation plan, contrary to the statutory intent.

B. Plans linked to cafeteria plans

Commentators expressed concern that changes to elections under a section 125 cafeteria plan could change the amount of eligible compensation used for purposes of a benefit formula under a nonqualified deferred compensation plan and thereby create an impermissible deferral election or acceleration of payment under the nonqualified deferred compensation plan. The final regulations provide relief from the deferral election-timing and anti-accelera-

tion rules for changes to section 125 elections properly made in accordance with the rules under section 125, to the extent that the change in the amount deferred under the nonqualified deferred compensation plan results solely from the application of the change in amount of eligible compensation resulting from the election change under the cafeteria plan to a benefit formula based upon the service provider's eligible compensation, and only to the extent that such change applies in the same manner as any other increase or decrease in the eligible compensation would apply to such benefit formula.

C. Offsets

i. In general

Some commentators requested clarification whether an arrangement under which a specified amount paid by a service recipient to a service provider reduces or offsets an amount that is payable to the service provider under a nonqualified deferred compensation plan will be treated as providing for an acceleration of a payment under the nonqualified deferred compensation plan. As an example, one commentator stated that a plan may require that any payout at separation from service of accrued leave that is determined to be in excess of the correct amount of such payment will be deducted from the amount due under a nonqualified deferred compensation plan, rather than repaid separately by the service provider. One commentator suggested that offsets be permitted for all service provider debts of a kind and in amounts customarily incurred in the ordinary course of the business relationship between the service provider and the service recipient.

The Treasury Department and the IRS believe that the unfettered discretion to settle debts between a service recipient and a service provider through offsets from payments of nonqualified deferred compensation is not consistent with the intent of the statute, because it creates opportunities to disguise accelerated payments of deferred compensation. Accordingly, amounts that currently or in the future may be offset against nonqualified deferred compensation are treated as payments of deferred compensation and may violate the anti-acceleration rules under section 409A. See

section VIII.A of this preamble. However, the Treasury Department and the IRS agree that the ability to offset small routine debts against amounts payable under a nonqualified deferred compensation plan is useful so that service recipients can avoid the administrative burden involved in paying deferred compensation amounts to a service provider while at the same time attempting to collect small amounts owed by the same service provider. Accordingly, the final regulations provide that payments of deferred compensation may be offset by amounts owed to the service recipient by the service provider, where such debt is incurred in the ordinary course of the service relationship, to the extent the entire offset in any taxable year does not exceed \$5,000 and the offset is taken at the same time and in the same amount as the debt otherwise would have been due from the service provider.

ii. *Social security benefits and disability benefits*

Commentators requested clarification of the treatment of nonqualified deferred compensation plans that offset benefits with payments received as Social Security benefits and disability benefits. A plan provision providing for a direct, dollar-for-dollar reduction of payments due under a nonqualified deferred compensation plan by the amount of payments received or receivable as Social Security benefits will not fail to provide for a fixed schedule of payments. However, the rule relates solely to direct reductions in deferred compensation benefits to reflect eligibility for, or payment of, Social Security benefits, and does not permit other changes in the time and form of benefit based upon a service provider's eligibility or elections related to Social Security benefits. A reduction in a nonqualified deferred compensation plan benefit equal to the amount receivable under a service recipient sponsored disability plan generally will be treated similarly, provided that a substantial number of service providers participate in the disability plan. However, to allow the payment schedule to qualify as a fixed schedule, the disability plan must be established before the date the service provider becomes disabled. In addition, any subsequent amendment to the disability plan or other change in the

benefit payable under the disability plan may result in an acceleration of a payment or a subsequent deferral under the nonqualified deferred compensation plan unless the facts and circumstances establish otherwise (for example, because the amendment or change results from actions taken by an independent third party, such as an unrelated insurer that issued a disability insurance policy for such disability plan, over which the service recipient and service provider have no control, or an action of the service recipient with respect to the disability plan that is generally applicable to a substantial number of other service providers who participate in such disability plan and has a material effect on the disability benefits of such other service providers).

XI. *Statutory Effective Dates*

A. *Effective dates – earned and vested amounts*

As provided in section 885(d) of the American Jobs Creation Act of 2004, section 409A generally is effective for amounts deferred after December 31, 2004. The final regulations adopt the definition set forth in the proposed regulations of an amount deferred on or before December 31, 2004, for purposes of the effective date, subject to the modifications described in this preamble. The final regulations clarify that the grandfathered amount includes any account balance that is earned and vested, as well as the present value of any earned and vested right to future account credits, even if such amounts had not been credited to the account as of December 31, 2004. For example, if a service provider had a vested right on December 31, 2004, to have a bonus amount added to the service provider's account balance in a nonqualified deferred compensation plan, the service provider's grandfathered amount would include the amount of such bonus even though such amount was not calculated and credited to the account until some time in 2005.

B. *Effective dates — calculation of grandfathered amount*

One commentator requested that the grandfathered amount in a nonaccount balance plan be expressed in terms of the form of benefit under the plan. So,

for example, where the normal benefit was expressed in the form of an annuity payable at a certain age, that is how the amount of the grandfathered benefit would also be expressed. The final regulations do not adopt this suggestion, but reach a similar result by providing that any actuarial assumptions and methods that were reasonable to use as of December 31, 2004, may continue to be used in subsequent years for purposes of determining the grandfathered amount.

C. *Material modifications*

Section 885(d)(2) of the American Jobs Creation Act of 2004 provides generally that amounts deferred in taxable years beginning before January 1, 2005, are treated as amounts deferred in a taxable year beginning on or after such date if the plan under which the deferral is made is materially modified after October 3, 2004. The final regulations adopt the definition set forth in the proposed regulations of a material modification for these purposes, subject to the changes described in this preamble.

For purposes of the definition of a material modification under the effective date rules, the final regulations incorporate the exclusions from the definition of a modification for purposes of the rules governing stock rights. For example, a change to a discounted grandfathered stock right that could be covered by section 409A if materially modified under the effective date rules, will not be treated as materially modified and subject to section 409A if the change would not be treated under the rules governing stock rights as a modification resulting in treatment as a new grant of a stock right or an extension resulting in treatment of the stock right as having had a deferral feature from the date of grant.

The final regulations provide that neither the amendment of a plan to include a provision allowing for a payment to a person other than the service provider due to the application of a domestic relations order, nor the making of a payment in compliance with a domestic relations order where a plan did not address the ability to make such a payment, is treated as a material modification for purposes of the grandfathering rules.

Commentators also requested that a grandfathered plan be permitted to remove a provision requiring a cancellation of

deferrals for a prescribed period of time under all nonqualified deferred compensation plans to receive a distribution from the grandfathered plan, without resulting in a material modification. Commentators argued that because the enforcement of such a provision by cancelling a current deferral election generally would result in an immediate violation of section 409A, the inability to remove the requirement that the deferral election be cancelled effectively nullifies the grandfathered right. Under the final regulations, an amendment to a grandfathered plan that changes such a provision to require a cancellation of deferrals for the equivalent period of time beginning with the first possible date that such a cancellation would not result in a prohibited accelerated payment (generally the beginning of the subsequent calendar year for a service provider with a calendar year taxable year) will not constitute a material modification. For example, taxpayers may amend an early distribution provision that requires the immediate cessation of deferrals for 12 months to apply only to deferrals over the first 12 month period with respect to which the service provider can make a timely deferral election, for example, by prohibiting deferrals of compensation attributable to services performed during the service provider's next taxable year.

Commentators requested clarification of the effect of a material modification of a plan. The specific consequences of a material modification of a plan are being considered as part of the anticipated guidance related to income inclusion and calculation. However, the final regulations provide that for amounts deferred in taxable years beginning before January 1, 2005, under a plan that is materially modified after October 3, 2004, whether the plan complies with the requirements of section 409A is determined by reference to the terms of the plan in effect, and any actions taken under the plan, on and after the date of the material modification. Accordingly, where the materially modified plan is compliant with section 409A and these regulations immediately following the material modification, the material modification generally will not itself result in a violation.

XII. *Applicability date of final regulations*

A. *Existing transition relief.*

Nothing in this preamble or the final regulations is intended to restrict the otherwise applicable transition relief. For a description of the applicable transition relief, see Notice 2006-79, 2006-43 I.R.B. 763 (extension of certain transition relief through 2007), Notice 2006-64, 2006-29 I.R.B. 88 (transition relief applicable to certain accelerated payments necessary to comply with Federal ethics requirements), Notice 2006-33, 2006-15 I.R.B. 754 (transition rules with respect to section 409A(b)), Notice 2006-4, 2006-3 I.R.B. 307 (transition relief with respect to the valuation standards applicable to stock rights issued on or before the effective date of the final regulations for purposes of the exclusion from coverage under section 409A for certain stock rights), the preamble to the proposed regulations (extension of certain transition relief through 2006), and Notice 2005-1, 2005-1 C.B. 274 (initial transition relief). See §601.601(d)(2).

B. *Application of final regulations*

The final regulations are generally applicable January 1, 2008. For periods before January 1, 2008, the standards and transition rules set forth in Notice 2006-79 continue to apply. For further information regarding the transition relief for periods before the applicability date of the final regulations, see Notice 2006-79 and section XI of the preamble to the proposed regulations.

Commentators requested clarification of the impact of the final regulations becoming applicable January 1, 2008, on plans that continue to defer compensation on or after January 1, 2008. Specifically, commentators asked whether actions taken with respect to nonqualified deferred compensation plans that would not have resulted in income inclusion under section 409A before 2008 because such actions were consistent with applicable guidance, but would not be consistent with the final regulations, would need to be modified to avoid income inclusion under section 409A in 2008 and later years. The following sections discuss the effect of the final regulations with respect to the requirements necessary to comply with section 409A, including the various requirements

necessary for a plan to be excluded from coverage under section 409A.

C. *Stock rights*

Many of the comments related to stock options and stock appreciation rights. Some commentators requested that section 409A not apply to any stock rights issued before the applicability date of the final regulations. Neither the statute nor the legislative history indicates an intent for such a broad exception. The Treasury Department and the IRS understand that certain aspects of the guidance on stock rights have changed. However, the final regulations generally expand the exclusion from coverage under section 409A for certain stock rights to eliminate many issues raised by the proposed regulations. In addition, with respect to certain types of stock rights, such as discounted stock options, the guidance has explicitly and consistently indicated that either rights that would be excluded from coverage under section 409A must be substituted for such rights or such rights must be modified to comply with section 409A. Accordingly, the final regulations do not adopt a categorical exclusion from coverage under section 409A of all stock rights issued before the issuance of the final regulations.

Commentators also asked whether a stock option must be repriced to avoid coverage under section 409A if the exercise price would be treated as having been set at fair market value under section 409A under the applicable guidance, but would not be treated as having been set at fair market value if the standard of the final regulations had been applicable. For this purpose, the guidance provided in Notice 2006-4, 2006-3 I.R.B. 307, see §601.601(d)(2), remains in effect. Notice 2006-4 provided certain standards applicable to stock rights issued before January 1, 2005, for determining whether the exercise price of such stock right would be treated as having been set at fair market value for purposes of the exclusion from coverage under section 409A for certain stock rights. As provided in Notice 2006-4, for stock rights issued before January 1, 2005, the standards applicable to incentive stock options under section 422 are applicable. Generally this means that where the sole reason the stock right would fail to qualify for the exclusion from

coverage under section 409A is due to the exercise price not being set at or above fair market value, the exercise price will be treated as set at or above fair market value if based upon a good faith attempt by the issuer to set the exercise price at or above fair market value. As further explained in Notice 2006-4, for stock rights issued on or after January 1, 2005, but before January 1, 2008, the provisions of Notice 2005-1 will apply, generally requiring that fair market value for purposes of setting the exercise price of a stock right must be determined using a reasonable valuation method. In addition, for stock rights issued on any date before January 1, 2008, taxpayers may rely upon the provisions of the proposed or final regulations with regard to the determination of the fair market value of the underlying stock.

Commentators requested that taxpayers not be required to bring stock rights granted before January 1, 2008, into compliance with section 409A if such rights were properly treated as not being subject to section 409A under the applicable guidance, but instead be permitted to keep such rights outstanding and unmodified.

The final regulations significantly expand the permissible classes of stock and the permissible issuers of stock under the service recipient stock rule, and taxpayers may rely on the final regulations for periods before the effective date of the final regulations. In addition, with respect to stock rights issued before April 10, 2007, on stock that would have constituted service recipient stock under a reasonable good faith interpretation of the statute and applicable guidance, but would not constitute service recipient stock under the final regulations, such stock will continue to constitute service recipient stock for purposes of applying section 409A to such stock right until the exercise or termination of such right, or until the stock right is modified in a manner that is treated as the grant of a new right. However, for a stock right issued on or after April 10, 2007, stock subject to such stock right will not be treated as service recipient stock after December 31, 2007, unless such stock satisfies the requirements of the final regulations, and if the stock does not satisfy these requirements, such stock right will be required to be modified either to be excluded from coverage under section 409A,

or to comply with the requirements of section 409A and these regulations.

Commentators also expressed concerns about modifications and extensions of stock rights that occur before January 1, 2008. Different concerns and arguments arise depending upon whether these modifications and extensions occurred on or before the enactment of the statute (October 23, 2004), on or before the issuance of Notice 2005-1 (December 20, 2004), on or before the issuance of the proposed regulations (September 30, 2005) or on or before the applicability date of the final regulations (January 1, 2008). The final regulations significantly expand the permissible types of modifications and extensions that will not result in treatment of the stock right as a new grant or as having had a deferral feature from the date of grant, and taxpayers may rely on these regulations for periods before the applicability date of the regulations. In addition, any modifications or extensions occurring before the enactment of the statute (October 23, 2004) will not be considered in determining whether the right is excluded from coverage under section 409A. Finally, any extension granted before April 10, 2007, solely in order to give the holder of a stock right an additional period of time within which to exercise the stock right beyond the time originally prescribed is disregarded for purposes of the rules treating certain extensions as deferral features from the time of grant. See §1.409A-1(b)(5)(v)(C).

D. Initial deferral elections

Commentators asked whether and to what extent the final regulations would impact initial deferral elections made before the applicability date of the final regulations. If a deferral election made before January 1, 2008, was consistent with the proposed regulations or the applicable transition guidance, the initial deferral election will be deemed to comply with the provisions of section 409A, regardless of whether the period of deferral extends beyond December 31, 2007.

In addition, commentators asked whether and to what extent the final regulations would impact programs established before the applicability date of the final regulations, where initial deferral elections have not been made by January 1,

2008. For example, commentators asked how section 409A would apply if a service recipient has interpreted a program as providing for performance-based compensation and permitted deferral elections to occur in 2008 or later in accordance with the rules governing deferrals of performance-based compensation, but such compensation does not qualify as performance-based compensation under the final regulations. For a program established before April 10, 2007, that under a reasonable, good faith interpretation of the statute and applicable guidance would have permitted an initial deferral election to be made after December 31, 2007, and on or before December 31, 2008, an initial deferral election will be deemed to comply with the initial deferral election rules if made by the deadline established in the plan. For a program established before April 10, 2007, that under a reasonable, good faith interpretation of the statute and applicable guidance would have permitted an initial deferral election be made after December 31, 2008, an initial deferral election will be deemed to comply with the initial deferral election rules if made by December 31, 2008.

E. Designation of time and form of payment

Notice 2005-1 and the preamble to the proposed regulations consistently provide that elections as to the time and form of payment of deferred compensation would need to be compliant with the final regulations by the time such regulations were applicable. Both Notice 2005-1 and the preamble to the proposed regulations provide detailed transition guidance, generally permitting service providers and service recipients to change the time and form of payment at any time through the end of the transition period. Accordingly, a payment scheme that violates the provisions of the final regulations will need to be brought into compliance with the final regulations in accordance with the transition relief.

F. Service providers in pay status

Commentators asked how the final regulations apply to service providers that are already in pay status, where the payment trigger is based upon a reasonable, good faith interpretation of the statute and applicable guidance but is not in compliance

with the final regulations. This may occur where the service provider has already begun receiving payments before January 1, 2008, or where all events necessary to receive the payment have occurred before January 1, 2008. For example, a service provider may have been treated as having separated from service before January 1, 2008, under a reasonable, good faith interpretation of the statute, but would not be treated as having separated from service under the final regulations. Where payments have commenced before January 1, 2008, the plan may continue to make such payments consistent with the application of the plan terms at the time the payments commenced, or may halt such payments on or before December 31, 2007, and amend the time and form of any remaining payments to comply with the final regulations in accordance with the transition guidance provided. Where payments have not commenced by January 1, 2008, but all the events necessary to receive the payment have occurred, the plan may make payments in accordance with the application of the plan terms on December 31, 2007, or may amend the time and form of payments to comply with section 409A in accordance with the transition guidance provided. Similarly, where payments have not commenced on or before December 31, 2007, because the service provider was treated as not having separated from service under a reasonable, good faith interpretation, but under the final regulations the service provider would be treated as having separated from service on or before December 31, 2007, the plan must treat the service provider as having separated from service on a date on or after April 10, 2007, and on or before December 31, 2007. Nothing in this paragraph is to be construed to permit the continuation of any payment schedule based upon an application of section 409A on or before December 31, 2007, that failed to meet the requirements of the applicable transition guidance. In addition, nothing in this paragraph is intended to waive the application of the constructive receipt doctrine or section 451 with respect to any discretion provided to the service provider (or former service provider) with respect to the application of these provisions.

In addition, commentators asked how the final regulations would apply in the case of the six-month delay for specified

employees of public corporations. Where a separation from service occurs on or before December 31, 2007, under circumstances that under a reasonable, good faith interpretation of the statute and applicable guidance would not result in application of the six-month delay requirement for a payment to a specified employee, the beginning or continuation of payments of deferred compensation on or after January 1, 2008, will not result in a violation of the six-month delay requirement for a payment to a specified employee.

XIII. *Additional Transition Relief*

A. *Collectively bargained plans*

Consistent with Notice 2006-79, §3.05, the final regulations provide that a nonqualified deferred compensation plan maintained pursuant to one or more collective bargaining agreements in effect on October 3, 2004, is not required to comply with the provisions of section 409A on or before the earlier of the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension of any agreement after October 3, 2004) or December 31, 2009.

With respect to amounts deferred under a nonqualified deferred compensation plan maintained pursuant to one or more collective bargaining agreements in effect on October 3, 2004, the plan may provide, or be amended to provide, for new payment elections with respect to both the time and form of payment of such amounts, and the election or amendment will not be treated as a change in the time or form of payment under section 409A(a)(4) or an acceleration of a payment under section 409A(a)(3), provided that the plan is so amended and elections are made before the date on which section 409A first applies to such plan. A deferral election may be made with respect to an amount that is a short-term deferral within the meaning of §1.409A-1(b)(4), provided that the election is made before the date on which section 409A would apply to an amount deferred under such plan and before January 1 of the calendar year in which the amount would otherwise have been paid.

B. *Requirement to amend plans on or before December 31, 2007*

Where there have been deferrals of compensation under a plan as of January 1, 2008 but the deferred compensation has not been paid, the plan must be made compliant with section 409A on or before December 31, 2007, with respect to such deferred compensation. These amendments are required only to bring the document into compliance effective January 1, 2008, and are not required to reflect any amendments made or actions taken under the transition rules to the extent such amendments or actions do not affect the plan's compliance with section 409A and these regulations for periods on or after January 1, 2008. For example, if a plan contains a haircut provision permitting an immediate distribution contingent on the forfeiture of a certain portion of a deferred amount, the haircut provision need not be removed retroactively for periods before January 1, 2008, where the plan has been operated in compliance with the applicable transition guidance (and thus no payment pursuant to the haircut provision has been made after December 31, 2004). In addition, a plan need not be amended to be made compliant with section 409A with respect to amounts deferred under the plan that were paid on or before December 31, 2007, in compliance with the transition guidance. However, the taxpayer must be able to demonstrate that the plan was operated in compliance with the transition guidance, including demonstrating that amounts were deferred or paid in compliance with the transition rules. For example, where payments were made in conjunction with elections of payment dates by either the service recipient or service provider during the transition period, the taxpayer must be able to demonstrate that the elections were provided and made in accordance with the transition rules.

XIV. *Calculation and Timing of Income Inclusion Amounts, Reporting and Withholding*

A. *In general*

These regulations do not address the calculation and timing of amounts required to be included in income under section 409A(a). Nor do these regulations address the reporting and withholding

requirements applicable to service recipients providing nonqualified deferred compensation covered by section 409A. The Treasury Department and the IRS intend to issue further guidance, including such transition guidance as may be appropriate with respect to the reporting and withholding requirements. See Notice 2006-100, 2006-51 I.R.B. 1109, for transition rules applicable to the reporting and withholding requirements for 2005 and 2006. See §601.601(d)(2).

B. Operational violations during the transition period

Commentators on the proposed regulations and Notice 2006-100 asked whether a service provider whose nonqualified deferred compensation plan violated section 409A in operation before January 1, 2008, would be required to include an amount in income under section 409A only in the taxable year of the service provider in which the operational failure occurred (assuming this was the only year of an operational failure), or in such year and all prior years beginning after December 31, 2004. Commentators argued that for years before the operational violation, the taxpayer could be treated as operating the plan in reasonable, good faith compliance with the statute and Notice 2005-1, and therefore should be required to include an amount in income under section 409A only for the year in which the operational violation occurred. For example, where a taxpayer exercised a discounted stock option covered by section 409A in 2006, commentators argued that the taxpayer should be treated as operating the plan in reasonable, good faith compliance with section 409A during 2005, so that the taxpayer would be required to include an amount in income as a result of the section 409A violation only to 2006.

Where an operational failure occurs in 2006 or 2007, and no operational failures occurred in any prior year, the taxpayer (including the service recipient) may report the amounts required to be included in income under section 409A as taxable income only in the year of the operational failure. In addition, where the violation results from a payment, a taxpayer may include the required amount in income only for the year in which such violation occurs, regardless of whether the portion of the

deferred compensation plan under which such payment was made is ever amended to comply with the requirements of section 409A for periods before such payment. For example, where a taxpayer exercises a discounted stock option subject to section 409A in 2006, and there was no operational violation in 2005, the taxpayer may include an amount in income under section 409A for 2006, and the taxpayer will not be required to include an amount in income with respect to such stock option for 2005, even if the taxpayer does not amend the stock option to comply with section 409A for 2005. However, where all or part of the total amount deferred in the year of the violation was also an amount deferred in one or more prior years that was not subject to a substantial risk of forfeiture in such year, taxpayers are also required to calculate and pay any applicable tax under section 409A(a)(1)(B)(i)(I) (based on the amount of interest determined under section 409A(a)(1)(B)(ii)). For example, if the discounted stock right in the previous example was not subject to a substantial risk of forfeiture as of December 31, 2005, the taxpayer would be required to compute and report the additional tax under section 409A(a)(1)(B)(i)(I) on the taxpayer's 2006 return. For purposes of this paragraph, the service recipient should treat the application of section 409A in the same manner for purposes of income tax withholding and reporting obligations.

C. Application of plan aggregation rules during the transition period

Notice 2006-100 provides that where there is a required income inclusion under section 409A in 2006, the plan aggregation rules apply in determining the amount includible in income. Commentators asked whether the plan aggregation rules would apply where the taxpayer violates section 409A in 2006 with respect to one arrangement (the first arrangement), but retains the right to modify another arrangement (the second arrangement) to exclude a right to an amount provided under the second arrangement from coverage under section 409A, where the second arrangement would otherwise be aggregated with the first arrangement. For this purpose, if the legally binding right to the amount under the second arrangement ultimately is modified (including, where per-

mitted by applicable guidance, by the substitution of another right for such right), so that the right to the amount is excluded from coverage under section 409A, then the right to the amount is treated as always having been excluded from coverage under section 409A. Accordingly, the amount payable under the second arrangement would not be required to be aggregated with the first arrangement for purposes of determining the amount includible in income under section 409A. However, if the right to the amount under the second arrangement is not timely modified to be excluded from coverage under section 409A, the right to the amount under the second arrangement will remain subject to the plan aggregation rules regardless of whether the second arrangement is, or is amended to be, compliant with the requirements of section 409A. In such a case, because the right to the amount under the second arrangement could have been modified to be excluded from coverage under section 409A, and would not have been subject to the plan aggregation rules, the violation with respect to the second arrangement is not treated as occurring until the first taxable year of the service provider during which the arrangement could not have been so modified.

For example, assume a taxpayer with a calendar year taxable year exercised a discounted stock right during 2006 in violation of section 409A and that the taxpayer held another unexercised discounted stock right described in Notice 2006-79, §3.07 (relating to certain stock rights issued to corporate insiders) that could have been modified by December 31, 2006, to be excluded from coverage (by exchanging such stock right for another stock right pursuant to the preamble to the proposed regulations). If the unexercised stock right was not so modified by December 31, 2006, it would violate section 409A on January 1, 2007. Alternatively, assume a second taxpayer exercised a discounted stock right in 2006 in violation of section 409A and that taxpayer held another unexercised discounted stock right (not described in Notice 2006-79, §3.07) that could have been modified by December 31, 2007, to be excluded from coverage. If the second taxpayer failed to timely modify such unexercised stock right, the unexercised stock right would violate section 409A on January 1, 2008.

D. Failures to amend during the transition period to comply with the rules of section 409A

Commentators asked how section 409A and these regulations would apply to a plan that was operated in compliance with the transition guidance through December 31, 2007, but is not amended to become compliant with section 409A and these regulations by December 31, 2007. For these purposes, the plan will be treated as failing to comply with the requirements of section 409A and these regulations as of January 1, 2008, so that no amounts will be required to be included in income under section 409A with respect to such a violation for any taxable year ending before January 1, 2008. However, this does not affect the application of the tax imposed by section 409A(a)(1)(B)(i)(I) to amounts that were deferred in taxable years ending before January 1, 2008, to the extent that such amounts were not subject to a substantial risk of forfeiture in one or more of such earlier taxable years.

XV. Offshore Trusts and Arrangements with Financial Triggers

These regulations do not address the application of section 409A(b), generally prohibiting the use of offshore trusts associated with nonqualified deferred compensation plans, and the use of triggers whereby amounts held in a trust or other arrangement become restricted to the use for payment of nonqualified deferred compensation upon an event related to the financial health of the service recipient. For transition guidance related to the application of section 409A(b) to certain outstanding arrangements, see Notice 2006-33, 2006-15 I.R.B. 754. See §601.601(d)(2). Taxpayers may continue to rely upon Notice 2006-33 until further guidance is issued.

Applicability Date

These regulations are applicable for taxable years beginning on or after January 1, 2008. Taxpayers may rely on the provisions of these final regulations for taxable years beginning before January 1, 2008.

Effect on Other Documents

Notice 2005-1, 2005-1 C.B. 274, is obsolete for taxable years beginning on or after January 1, 2008, except for the following sections of the guidance which remain effective as modified by any other applicable guidance: Q&A-6 (application to arrangements covered by section 457); Q&A-7 (application to arrangements between a partnership and a partner of the partnership); and Q&A-24 through Q&A-38 (information reporting and withholding guidance). For a discussion of the effect of reliance upon Notice 2005-1 or the proposed regulations for taxable years beginning before January 1, 2008, for arrangements continuing into taxable years beginning on or after January 1, 2008, see section XII of this preamble. See §601.601(d)(2).

Notice 2006-4, 2006-3 I.R.B. 307, addressing certain stock rights issued before January 1, 2008, is superseded by these final regulations with respect to stock rights issued in taxable years of the service provider beginning on or after January 1, 2008. For a discussion of the effect of reliance upon Notice 2005-1, Notice 2006-4, or the proposed regulations for taxable years beginning before January 1, 2008, for stock rights remaining outstanding on or after January 1, 2008, see section XII of this preamble.

Notice 2006-33, 2006-15 I.R.B. 754, Notice 2006-79, 2006-43 I.R.B. 763, and Notice 2006-100, 2006-51 I.R.B. 1109, are not affected by these final regulations. Notice 2006-64, 2006-29 I.R.B. 88, is superseded by the final regulations effective for taxable years of a service provider beginning on or after January 1, 2008. See §601.601(d)(2).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to sec-

tion 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Stephen Tackney of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:
Authority: 26 U.S.C. 7805 * * *

Par. 2. Sections 1.409A-0 through 1.409A-6 are added to read as follows:

§1.409A-0 Table of contents.

This section lists captions contained in §§1.409A-1, 1.409A-2, 1.409A-3, 1.409A-4, 1.409A-5 and 1.409A-6.

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§1.409A-1 Definitions and covered plans.

(a) *Nonqualified deferred compensation plan*—(1) *In general*. Except as otherwise provided in this paragraph (a), the term *nonqualified deferred compensation plan* means any plan (within the meaning of paragraph (c) of this section) that provides for the deferral of compensation (within the meaning of paragraph (b) of this section). Whether a plan provides for the deferral of compensation generally is determined at the time the service provider obtains a legally binding right to the compensation under the plan, and is not affected by any retroactive change to the plan to characterize the right as one that does not provide for the deferral of compensation. For example, amounts deferred under a nonqualified deferred compensation plan do not become an excluded death benefit if the plan is amended so that the amounts are payable only upon the death of the service provider. If a principal

purpose of a plan is to achieve a result with respect to a deferral of compensation that is inconsistent with the purposes of section 409A, the Commissioner may treat the plan as a nonqualified deferred compensation plan for purposes of section 409A and the regulations thereunder.

(2) *Qualified employer plans*. The term *nonqualified deferred compensation plan* does not include a qualified employer plan. The term *qualified employer plan* means any of the following plans:

(i) Any plan described in section 401(a) and a trust exempt from tax under section 501(a) or that is described in section 402(d).

(ii) Any annuity plan described in section 403(a).

(iii) Any annuity contract described in section 403(b).

(iv) Any simplified employee pension (within the meaning of section 408(k)).

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(vi) Any plan under which an active participant makes deductible contributions to a trust described in section 501(c)(18).

(vii) Any eligible deferred compensation plan (within the meaning of section 457(b)).

(viii) Any plan described in section 415(m).

(ix) Any plan described in §1022(i)(2) of the Employee Retirement Income Security Act of 1974, Public Law 93-406 (88 Stat. 829, 942) (Sept. 2, 1974) (ERISA).

(3) *Certain foreign plans*—(i) *Participation addressed by treaty*. With respect to an individual for a taxable year, the term *nonqualified deferred compensation plan* does not include any scheme, trust, arrangement, or plan maintained with respect to such individual, to the extent contributions made by or on behalf of such individual to such scheme, trust, arrangement, or plan, or credited allocations, accrued benefits, earnings, or other amounts constituting income, of such individual under such scheme, trust, arrangement, or plan, are excludable by such individual for Federal income tax purposes pursuant to any bilateral income tax convention, or other bilateral or multilateral agreement, to which the United States is a party.

(ii) *Participation by nonresident aliens, certain resident aliens, and bona fide residents of possessions*. With respect to an alien individual for a taxable year

during which such individual is a nonresident alien, a resident alien classified as a resident alien solely under section 7701(b)(1)(A)(ii) (and not section 7701(b)(1)(A)(i)), or a *bona fide* resident of a possession (within the meaning of section 937(a)), the term *nonqualified deferred compensation plan* does not include any broad-based foreign retirement plan (within the meaning of paragraph (a)(3)(v) of this section).

(iii) *Participation by U.S. citizens and lawful permanent residents.* With respect to an individual for a given taxable year during which such individual is a U.S. citizen or a resident alien classified as a resident alien under section 7701(b)(1)(A)(i), other than an individual who is also a *bona fide* resident of a possession (within the meaning of section 937(a)), the term *nonqualified deferred compensation plan* does not include a broad-based foreign retirement plan (within the meaning of paragraph (a)(3)(v) of this section), but only with respect to a plan, or a portion of a plan where such portion may be distinguished, providing for nonelective deferrals of modified foreign earned income, and earnings with respect to such nonelective deferrals, and only to the extent that the amounts deferred under all such plans of the service recipient, or all portions of such plans, in which the service provider participates in such taxable year, do not exceed the applicable limits under section 415(b) (applied to nonaccount balance plans as defined in paragraph (c)(2)(i)(C) of this section) and section 415(c) (applied to account balance plans as defined in paragraph (c)(2)(i)(A) of this section) that would be applicable if such plans were plans subject to section 415 and the modified foreign earned income of such individual were treated as compensation for purposes of applying section 415(b) and (c). For purposes of this paragraph (a)(3)(iii), the term *modified foreign earned income* means foreign earned income as defined in section 911(b)(1) without regard to section 911(b)(1)(B)(iv) and without regard to the requirement that the income be attributable to services performed during the period described in section 911(d)(1)(A) or (B). The provisions of this paragraph (a)(3)(iii) do not apply to any individual with respect to any taxable year in which the individual is simultaneously eligible

to participate in a broad-based foreign retirement plan and a qualified employer plan described in paragraph (a)(2) of this section. For purposes of this paragraph (a)(3)(iii), an individual is eligible to participate in a qualified employer plan if under the terms of the plan and without further amendment or action by the plan sponsor, the individual is eligible to make or receive contributions or accrue benefits under the plan (regardless of whether the individual has elected to participate in the plan).

(iv) *Plans subject to a totalization agreement and similar plans.* The term *nonqualified deferred compensation plan* does not include any social security system of a jurisdiction to the extent that benefits provided under or contributions made to the system are subject to an agreement entered into pursuant to section 233 of the Social Security Act (42 U.S.C. 433) with any foreign jurisdiction. In addition, the term *nonqualified deferred compensation plan* does not include a social security system of a foreign jurisdiction to the extent that benefits are provided under or contributions are made to a government-mandated plan as part of that foreign jurisdiction's social security system.

(v) *Broad-based foreign retirement plan.* The term *broad-based foreign retirement plan* means a scheme, trust, arrangement, or plan (regardless of whether sponsored by a U.S. person) that is written and that, in the case of an employer-maintained plan, satisfies the following conditions:

(A) The plan is nondiscriminatory insofar as the employees who, under the terms of the plan (alone or in combination with other comparable plans) and without further amendment or action by the employer, are eligible to make or receive contributions or accrue benefits under the plan other than earnings (regardless of whether the employee has elected to participate in the plan), are a wide range of employees, substantially all of whom are nonresident aliens, resident aliens classified as resident aliens solely under section 7701(b)(1)(A)(ii) (and not section 7701(b)(1)(A)(i)), or *bona fide* residents of a possession (within the meaning of section 937(a)), including rank and file employees.

(B) The plan (alone or in combination with other comparable plans) actually pro-

vides significant benefits for a substantial majority of such covered employees.

(C) The benefits actually provided under the plan to such covered employees are nondiscriminatory.

(D) The plan contains provisions or is the subject of tax law provisions or other legal restrictions that generally discourage employees from using plan benefits for purposes other than retirement or restrict access to plan benefits before separation from service, including (but not limited to), restricting in-service distributions except in events similar to an unforeseeable emergency (as defined in §1.409A-3(i)(3)(i)) or hardship (as defined for purposes of section 401(k)(2)(B)(i)(IV)), or for educational purposes or the purchase of a primary residence.

(4) *Section 457 plans.* A nonqualified deferred compensation plan under section 457(f) may constitute a nonqualified deferred compensation plan for purposes of this paragraph (a). The rules of section 409A apply to nonqualified deferred compensation plans separately and in addition to any requirements applicable to such plans under section 457(f). In addition, nonelective deferred compensation of non-employees described in section 457(e)(12) and a grandfathered plan or arrangement described in §1.457-2(k)(4) may constitute a nonqualified deferred compensation plan for purposes of this paragraph (a). The term *nonqualified deferred compensation plan* does not include a length of service award to a *bona fide* volunteer under section 457(e)(11)(A)(ii). For purposes of the application of section 409A to a plan to which section 457 applies, a payment under the plan generally means the provision of cash or property to the service provider, provided that for purposes of the application of the short-term deferral rule set forth in paragraph (b)(4) of this section, the inclusion in income of an amount under section 457(f) is treated as a payment of the amount.

(5) *Certain welfare benefits.* The term *nonqualified deferred compensation plan* does not include a plan, or a portion of a plan, to the extent that the plan provides *bona fide* vacation leave, sick leave, compensatory time, disability pay, or death benefits. For these purposes, the term "disability pay" and "death benefits" have the same meanings as provided

in §31.3121(v)(2)–1(b)(4)(iv)(C) of this chapter, provided that for purposes of this paragraph, such disability pay and death benefits may be provided through insurance and the lifetime benefits payable under the plan are not treated as including the value of any taxable term life insurance coverage or taxable disability insurance coverage provided under the plan. The term *nonqualified deferred compensation plan* also does not include any Archer Medical Savings Account as described in section 220, any Health Savings Account as described in section 223, or any other medical reimbursement arrangement, including a health reimbursement arrangement, that satisfies the requirements of section 105 and section 106 such that the benefits or reimbursements provided under such arrangement are not includible in income.

(b) *Deferral of compensation*—(1) *In general.* Except as otherwise provided in paragraphs (b)(3) through (b)(12) of this section, a plan provides for the deferral of compensation if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable to (or on behalf of) the service provider in a later taxable year. Such compensation is deferred compensation for purposes of section 409A, this section and §§1.409A–2 through 1.409A–6. A legally binding right to an amount that will be excluded from income when and if received does not constitute a deferral of compensation, unless the service provider has received the right in exchange for, or has the right to exchange the right for, an amount that will be includible in income (other than due to participation in a cafeteria plan described in section 125). A service provider does not have a legally binding right to compensation to the extent that compensation may be reduced unilaterally or eliminated by the service recipient or other person after the services creating the right to the compensation have been performed. However, if the facts and circumstances indicate that the discretion to reduce or eliminate the compensation is available or exercisable only upon a condition, or the discretion to reduce or eliminate the compensation lacks substantive significance, a service provider will be considered to have

a legally binding right to the compensation. Whether the discretion to reduce or eliminate the compensation lacks substantive significance depends on all the relevant facts and circumstances. However, where the service provider to whom the compensation may be paid has effective control of the person retaining the discretion to reduce or eliminate the compensation, or has effective control over any portion of the compensation of the person retaining the discretion to reduce or eliminate the compensation, or is a member of the family (as defined in section 267(c)(4)) applied as if the family of an individual includes the spouse of any member of the family) of the person retaining the discretion to reduce or eliminate the compensation, the discretion to reduce or eliminate the compensation will not be treated as having substantive significance. For this purpose, compensation is not considered subject to unilateral reduction or elimination merely because it may be reduced or eliminated by operation of the objective terms of the plan, such as the application of a nondiscretionary, objective provision creating a substantial risk of forfeiture. Similarly, a service provider does not fail to have a legally binding right to compensation merely because the amount of compensation is determined under a formula that provides for benefits to be offset by benefits provided under another plan (including a plan that is qualified under section 401(a)), or because benefits are reduced due to actual or notional investment losses, or, in a final average pay plan, subsequent decreases in compensation.

(2) *Earnings.* References to the deferral of compensation or deferred compensation include references to earnings. When the right to earnings is specified under the terms of the plan, the legally binding right to earnings arises at the time of the deferral of the compensation to which the earnings relate. A plan may provide that the time and form of payment of earnings is treated separately from the time and form of payment of the underlying compensation, so that, provided that the rules of section 409A are otherwise met, a plan may provide that earnings will be paid at a separate time or in a separate form from the payment of the underlying compensation. For the application of the deferral election rules to current payments of earnings and dividend equivalents, see §1.409A–3(e).

(3) *Compensation payable pursuant to the service recipient's customary payment timing arrangement.* A deferral of compensation does not occur solely because compensation is paid after the last day of the service provider's taxable year pursuant to the timing arrangement under which the service recipient normally compensates service providers for services performed during a payroll period described in section 3401(b), or with respect to a non-employee service provider, a period not longer than the payroll period described in section 3401(b) or if no such payroll period exists, a period not longer than the earlier of the normal timing arrangement under which the service provider normally compensates non-employee service providers or 30 days after the end of the service provider's taxable year.

(4) *Short-term deferrals*—(i) *In general.* A deferral of compensation does not occur under a plan with respect to any payment (as defined in §1.409A–2(b)(2)) that is not a deferred payment, provided that the service provider actually or constructively receives such payment on or before the last day of the applicable 2½ month period. The following rules apply for purposes of this paragraph (b)(4)(i):

(A) The applicable 2½ month period is the period ending on the later of the 15th day of the third month following the end of the service provider's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture or the 15th day of the third month following the end of the service recipient's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture.

(B) A payment is treated as actually or constructively received if the payment is includible in income, including if the payment is includible in income under section 83, the economic benefit doctrine, section 402(b), or section 457(f).

(C) A right to a payment that is never subject to a substantial risk of forfeiture is considered to be no longer subject to a substantial risk of forfeiture on the first date the service provider has a legally binding right to the payment.

(D) A payment is a deferred payment if it is made pursuant to a provision of a plan that provides for the payment to be made or completed on or after any date, or

upon or after the occurrence of any event, that will or may occur later than the end of the applicable 2½ month period, such as a separation from service, death, disability, change in control event, specified time or schedule of payment, or unforeseeable emergency, regardless of whether an amount is actually paid as a result of the occurrence of such a payment date or event during the applicable 2½ month period. If a plan provides that the service provider or service recipient may make an election under the plan (including an election under §1.409A-2(a)(4)) of a different payment date, schedule, or event, such right is disregarded for this purpose. In such cases, whether a plan provides for a deferred payment is determined based on the payment date, schedule, or event that would apply if no such election were made, except that if the plan would not provide for a deferred payment absent such an election, and the service provider or service recipient makes such an election, whether the plan provides for a deferred payment is determined based upon the payment date, schedule, or event that the service provider or service recipient in fact elected.

(E) A stock right provides for a deferred payment if such right includes any provision pursuant to which the holder of the stock right will or may have the right to exercise the stock right after the applicable 2½ month period.

(F) This paragraph (b)(4)(i) is applied separately to each payment (as defined in §1.409A-2(b)(2)) required to be made under a plan.

(G) If a plan provides for a deferred payment with respect to part of a payment (for example a life annuity or a series of installment amounts treated as a single payment), the plan provides for a deferred payment with respect to the entire payment.

(ii) *Certain delayed payments.* A payment that otherwise qualifies as a short-term deferral under paragraph (b)(4)(i) of this section but is made after the applicable 2½ month period may continue to qualify as a short-term deferral if the taxpayer establishes that it was administratively impracticable to make the payment by the end of the applicable 2½ month period and, as of the date upon which the legally binding right to the compensation arose, such impracticability was unforeseeable, or the taxpayer establishes that making the payment by the end of the

applicable 2½ month period would have jeopardized the ability of the service recipient to continue as a going concern, and provided further that the payment is made as soon as administratively practicable or as soon as the payment would no longer have such effect. For purposes of this paragraph (b)(4)(ii), an action or failure to act of the service provider or a person under the service provider's control, such as a failure to provide necessary information or documentation, is not an unforeseeable event. In addition, a payment that otherwise qualifies as a short-term deferral under paragraph (b)(4)(i) of this section but is made after the applicable 2½ month period may continue to qualify as a short-term deferral if the taxpayer establishes that the service recipient reasonably anticipated that the service recipient's deduction with respect to such payment otherwise would not be permitted by application of section 162(m), and, as of the date the legally binding right to the payment arose, a reasonable person would not have anticipated the application of section 162(m) at the time of the payment, and provided further that the payment is made as soon as reasonably practicable following the first date on which the service recipient anticipates or reasonably should anticipate that, if the payment were made on such date, the service recipient's deduction with respect to such payment would no longer be restricted due to the application of section 162(m). For additional rules applicable to certain transaction-based compensation, see §1.409A-3(i)(5)(iv)(A).

(iii) *Examples.* The following examples illustrate the provisions of this paragraph (b)(4). In these examples, except as otherwise noted, each employee and each employer has a calendar year taxable year and each employee is an individual who is employed by the specified employer.

Example 1. On November 1, 2008, Employer Z awards a bonus to Employee A such that Employee A has a legally binding right to the payment as of November 1, 2008, that is not subject to a substantial risk of forfeiture. The bonus plan does not provide for a payment date or a deferred payment. The bonus plan will not be considered to have provided for a deferral of compensation if the bonus is paid or made available to Employee A on or before March 15, 2009.

Example 2. Employer Y has a taxable year ending August 31. On November 1, 2008, Employer Y awards a bonus to Employee B so that Employee B has a legally binding right to the payment as of November 1, 2008, that is not subject to a substantial

risk of forfeiture. The bonus plan does not provide for a payment date or a deferred payment. The bonus plan will not be considered to have provided for a deferral of compensation if the bonus is paid or made available to Employee B on or before November 15, 2009.

Example 3. On November 1, 2008, Employer X awards a bonus to Employee C such that Employee C has a legally binding right to the payment as of November 1, 2008. Under the bonus plan, Employee C will forfeit the bonus unless Employee C continues performing services through December 31, 2010. The right to the payment is subject to a substantial risk of forfeiture through December 31, 2010. Employee C has the right to make a written election not later than December 31, 2009, to receive the bonus on or after December 31, 2015, but Employee C does not make such election. The bonus plan does not provide for a default payment date or a deferred payment in the absence of an election by Employee C. The bonus plan will not be considered to have provided for a deferral of compensation if the bonus is paid or made available to Employee C on or before March 15, 2011.

Example 4. On November 1, 2008, Employer W awards a bonus to Employee D such that Employee D has a legally binding right to the payment as of November 1, 2008. Under the bonus plan, the bonus will be determined based on services performed during the period from January 1, 2009 through December 31, 2010. The bonus is scheduled to be paid as a lump sum payment on February 15, 2011. Under the bonus plan, Employee D will forfeit the bonus unless Employee D continues performing services through the scheduled payment date (February 15, 2011). Provided that at all times before the scheduled payment date Employee D is required to continue to perform services to retain the right to the bonus, and the bonus is paid on or before March 15, 2012, the bonus plan will not be considered to have provided for a deferral of compensation.

Example 5. On November 1, 2008, Employer V awards a bonus to Employee E such that Employee E has a legally binding right to the payment as of November 1, 2008. Under the bonus plan, Employee E will forfeit the bonus unless Employee E continues performing services through December 31, 2010. Under the bonus plan, the bonus is scheduled to be paid as a lump sum payment on July 1, 2011. By specifying a payment date after the applicable 2½ month period, the bonus plan provides for a deferred payment. The bonus plan provides for a deferral of compensation, and will not qualify as a short-term deferral regardless of whether the bonus is paid or made available on or before March 15, 2011 (and generally any payment before June 1, 2011 would constitute an impermissible acceleration of a payment).

Example 6. On November 1, 2008, Employer U awards a bonus to Employee F such that Employee F has a legally binding right to the payment as of November 1, 2008, that is not subject to a substantial risk of forfeiture. The bonus plan provides for a lump sum payment upon Employee F's separation from service. Because the separation from service is an event that may occur after the applicable 2½ month period, the bonus plan provides for a deferred payment and therefore provides for a deferral of compensation. Accordingly, the bonus plan will not qualify as a short-term deferral regardless of whether Em-

ployee F separates from service and the bonus is paid or made available on or before March 15, 2009.

Example 7. On November 1, 2008, Employer T grants Employee G a legally binding right to the payment of a life annuity with the first annuity payment on November 1, 2013, provided that Employee G continues performing services for Employer T continuously through November 1, 2013. Because the life annuity is treated as a single payment, and because all payments of the life annuity may not occur during the applicable 2½ month period, the plan provides for a deferred payment and none of the amounts payable under the annuity will qualify as a short-term deferral, so that section 409A applies to all amounts that are payable under the plan.

Example 8. On November 1, 2008, Employer S grants Employee H a stock right providing for an exercise price less than the fair market value of the underlying stock on November 1, 2008. The stock right is subject to a substantial risk of forfeiture requiring services through November 1, 2010. The stock right becomes exercisable when the substantial risk of forfeiture lapses and expires on November 1, 2013. Employee H continues providing services through November 1, 2010, at which time the substantial risk of forfeiture lapses. The stock right provides for a deferred payment and will not qualify as a short-term deferral regardless of whether Employee H exercises the stock right on or before March 15, 2011.

(5) *Stock options, stock appreciation rights, and other equity-based compensation*—(i) *Stock rights*—(A) *Nonstatutory stock options not providing for the deferral of compensation.* An option to purchase service recipient stock does not provide for a deferral of compensation if—

(1) The exercise price may never be less than the fair market value of the underlying stock (disregarding lapse restrictions as defined in §1.83–3(i)) on the date the option is granted and the number of shares subject to the option is fixed on the original date of grant of the option;

(2) The transfer or exercise of the option is subject to taxation under section 83 and §1.83–7; and

(3) The option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of the following:

(i) The exercise or disposition of the option under §1.83–7.

(ii) The time the stock acquired pursuant to the exercise of the option first becomes substantially vested (as defined in §1.83–3(b)).

(B) *Stock appreciation rights not providing for the deferral of compensation.* A right to compensation based on the appreciation in value of a specified number of shares of service recipient stock occurring between the date of grant and the date of

exercise of such right (a stock appreciation right) does not provide for a deferral of compensation if—

(1) Compensation payable under the stock appreciation right cannot be greater than the excess of the fair market value of the stock (disregarding lapse restrictions as defined in §1.83–3(i)) on the date the stock appreciation right is exercised over an amount specified on the date of grant of the stock appreciation right (the stock appreciation right exercise price), with respect to a number of shares fixed on or before the date of grant of the right;

(2) The stock appreciation right exercise price may never be less than the fair market value of the underlying stock (disregarding lapse restrictions as defined in §1.83–3(i)) on the date the right is granted; and

(3) The stock appreciation right does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the stock appreciation right.

(C) *Stock rights that may provide for the deferral of compensation.* An option to purchase stock other than service recipient stock, or a stock appreciation right with respect to stock other than service recipient stock, generally will provide for the deferral of compensation within the meaning of this paragraph (b). If under the terms of an option to purchase service recipient stock (other than an incentive stock option described in section 422 or a stock option granted under an employee stock purchase plan described in section 423), the exercise price is or could become less than the fair market value of the stock (disregarding lapse restrictions as defined in §1.83–3(i)) on the date of grant, the grant of the option generally will provide for the deferral of compensation within the meaning of this paragraph (b). If under the terms of a stock appreciation right with respect to service recipient stock, the compensation payable under the stock appreciation right is or could be any amount greater than, with respect to a predetermined number of shares, the excess of the fair market value of the stock (disregarding lapse restrictions as defined in §1.83–3(i)) on the date the stock appreciation right is exercised over the fair market value of the stock (disregarding lapse restrictions as defined in §1.83–3(i)) on the date of grant of the stock appreciation right, the grant of the stock

appreciation right generally will provide for a deferral of compensation within the meaning of this paragraph (b).

(D) *Feature for the deferral of compensation.* To the extent a stock right provides a right other than the right to receive cash or stock on the date of exercise and such additional right would otherwise allow compensation to be deferred beyond the date of exercise, the entire arrangement (including the underlying stock right) provides for the deferral of compensation. For purposes of this paragraph (b)(5)(i), neither the right to receive substantially nonvested stock (as defined in §1.83–3(b)) upon the exercise of a stock right, nor the right to pay the exercise price with previously acquired shares, constitutes a feature for the deferral of compensation.

(E) *Rights to dividends.* For purposes of this paragraph (b)(5)(i), the right, directly or indirectly contingent upon the exercise of a stock right, to receive an amount equal to all or part of the dividends or other distributions (other than stock dividends described in paragraph (b)(5)(v)(H) of this section) declared and paid on the number of shares underlying the stock right between the date of grant and the date of exercise of the stock right constitutes an offset to the exercise price of the stock option or an increase in the amount payable under the stock appreciation right (generally causing such stock right to be subject to section 409A). A plan providing a right to dividends or other distributions declared and paid on the number of shares underlying a stock right, the payment of which is not contingent upon, or otherwise payable on, the exercise of the stock right, may provide for a deferral of compensation, but the existence of the right to receive such an amount will not be treated as a reduction to the exercise price of (or an increase to the compensation payable under) the stock right. Thus, a right to such dividends or distributions that is not contingent, directly or indirectly, upon the exercise of a stock right will not cause the related stock right to fail to satisfy the requirements of the exclusion from the definition of a deferral of compensation provided in paragraphs (b)(5)(i)(A) and (B) of this section.

(ii) *Statutory stock options.* The grant of an incentive stock option as described in section 422, or the grant of an option under an employee stock purchase

plan described in section 423 (including the grant of an option with an exercise price discounted in accordance with section 423(b)(6) and the accompanying regulations), does not constitute a deferral of compensation. However, the exclusion for statutory stock options under this paragraph (b)(5)(ii) does not apply to a modification, extension, or renewal of a statutory option that is treated as the grant of a new option that is not a statutory option. See §1.424-1(e). In such event, the option is treated for purposes of this paragraph (b) as if it had been a nonstatutory stock option from the date of the original grant. Accordingly, if such modification, extension, or renewal of the stock option would have been treated as the grant of a new option or as causing the option to have had a deferral feature from the date of grant under paragraph (b)(5)(v) of this section, the modification, extension, or renewal of the stock option is treated as the grant of a new option or as causing the option to have had a deferral feature from the date of grant for purposes of this paragraph (b)(5).

(iii) *Service recipient stock*—(A) *In general*. Except as otherwise provided in paragraphs (b)(5)(iii)(B), (C), and (D) of this section, the term *service recipient stock* means a class of stock that, as of the date of grant, is common stock for purposes of section 305 and the regulations thereunder of a corporation that is an eligible issuer of service recipient stock (as defined in paragraph (b)(5)(iii)(E) of this section). Notwithstanding the foregoing, the term *service recipient stock* does not include a class of stock that has any preference as to distributions other than distributions of service recipient stock and distributions in liquidation of the issuer. The term *service recipient stock* also does not include any stock that is subject to a mandatory repurchase obligation (other than a right of first refusal), or a put or call right that is not a lapse restriction as defined in §1.83-3(i), if the stock price under such right or obligation is based on a measure other than the fair market value (disregarding lapse restrictions as defined in §1.83-3(i)) of the equity interest in the corporation represented by the stock.

(B) *American depositary receipts*. An American depositary receipt or American depositary share may constitute service recipient stock, to the extent that the stock

traded on a foreign securities market to which the American depositary receipt or American depositary share relates qualifies as service recipient stock.

(C) *Mutual company units*. Mutual company units may constitute service recipient stock. For this purpose, the term *mutual company unit* means a fixed percentage of the overall value of a non-stock mutual company or association. For purposes of determining the value of the mutual company unit, the unit may be valued in accordance with the rules set forth in paragraph (b)(5)(iv)(B) of this section governing valuation of service recipient stock the shares of which are not traded on an established securities market, applied as if the mutual company were a stock corporation with one class of common stock and the number of shares of such stock determined according to such fixed percentage. For example, an appreciation right based on the appreciation of 10 mutual company units, where each unit is defined as one percent of the overall value of the mutual company, would be valued as if the appreciation right were based upon 10 shares of a corporation, with 100 shares of common stock (and no other class of stock), the shares of which are not readily tradable on an established securities market.

(D) *Other entities*. An interest in an entity other than a corporation or non-stock mutual company or association may constitute service recipient stock to the extent designated by the Commissioner in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(E) *Eligible issuer of service recipient stock*—(1) *In general*. The term *eligible issuer of service recipient stock* means only the corporation for which the service provider provides direct services on the date of grant of the stock right (if the entity receiving such services is a corporation), and any corporation in a chain of corporations or other entities in which each corporation or other entity has a controlling interest in another corporation or other entity in the chain, ending with the corporation or other entity that has a controlling interest in the corporation or other entity for which the service provider provides direct services on the date of grant of the stock right. For this purpose, the term *con-*

trolling interest has the same meaning as provided in §1.414(c)-2(b)(2)(i), provided that the language “at least 50 percent” is used instead of “at least 80 percent” each place it appears in §1.414(c)-2(b)(2)(i). In addition, where the use of such stock with respect to the grant of a stock right to such service provider is based upon legitimate business criteria, the term *controlling interest* has the same meaning as provided in §1.414(c)-2(b)(2)(i), provided that the language “at least 20 percent” is used instead of “at least 80 percent” each place it appears in §1.414(c)-2(b)(2)(i). For purposes of determining ownership of an interest in an organization, the rules of §§1.414(c)-3 and 1.414(c)-4 apply. The determination of whether a grant is based on legitimate business criteria is based on the facts and circumstances, focusing primarily on whether there is a sufficient nexus between the service provider and the issuer of the stock right so that the grant serves a legitimate non-tax business purpose other than simply providing compensation to the service provider that is excluded from the requirements of section 409A. For example, stock of a corporation that owns an interest in a joint venture involving an operating business, used with respect to stock rights granted to service providers of the joint venture who are former service providers of such corporation, generally will constitute use of service recipient stock based upon legitimate business criteria, and therefore could constitute service recipient stock with respect to such service providers if the corporation owns at least 20 percent of the joint venture and the other requirements of this paragraph (b)(5)(iii) are met. Similarly, the legitimate business criteria requirement generally would be met if the corporate venturer issued such a right to an employee of the joint venture who it reasonably expected would in the future become an employee of the corporate venturer. However, where a service provider has no real nexus with a corporate venturer, such as generally happens when the corporate venturer is a passive investor in the service recipient joint venture, a stock right issued to that employee on the investor corporation’s stock generally would not be based upon legitimate business criteria. Similarly, where a corporation holds only a minority interest in an entity that in turn holds a minority interest in the entity

for which the service provider performs services, such that the corporation holds only an insubstantial indirect interest in the entity receiving the services, legitimate business criteria generally would not exist for issuing a stock right on the corporation's stock to the service provider.

(2) *Investment vehicles.* Notwithstanding the provisions of paragraph (b)(5)(iii)(E)(I) of this section, except as to a service provider providing services directly to such corporation, for purposes of this paragraph (b)(5), an eligible issuer of service recipient stock does not include any corporation whose primary purpose is to serve as an investment vehicle with respect to the corporation's minority ownership interests in entities other than the service recipient.

(3) *Corporate structures established or transactions undertaken for purposes of avoiding coverage under section 409A.* Notwithstanding the provisions of paragraph (b)(5)(iii)(E)(I) of this section, an eligible issuer of service recipient stock does not include any corporation within a group of entities treated as a single service recipient if a purpose of the establishment of the structure of the ownership, or a purpose of a significant transaction between or among two or more entities comprising a single service recipient, is to provide deferred compensation not subject to the application of section 409A. If an entity becomes a member of a group of corporations or other entities treated as a single service recipient, and the primary source of income or value of such entity arises from the provision of management services to other members of the service recipient group, it is presumed that such structure was established for purposes of avoiding the application of section 409A if any stock rights are issued with respect to such entity.

(4) *Substitutions and assumptions by reason of a corporate transaction.* If the requirements of paragraph (b)(5)(v)(D) of this section are met such that the substitution of a new stock right pursuant to a corporate transaction for an outstanding stock right, or the assumption of an outstanding stock right pursuant to a corporate transaction, would not be treated as the grant of a new stock right or a change in the form of payment for purposes of this section and §§1.409A-2 through 1.409A-6, the stock underlying the stock right that replaced the

stock right that is substituted or assumed will be treated as service recipient stock for purposes of applying this paragraph (b)(5) to the replacement stock rights if such underlying stock otherwise satisfies the requirements of paragraph (b)(5)(iii)(A) of this section. For example, if by reason of a spinoff transaction (under which the stock of a subsidiary corporation is distributed to the stockholders of a distributing corporation), a stock option to purchase distributing corporation stock is replaced with a stock option to purchase distributing corporation stock and a stock option to purchase the spun off subsidiary corporation's stock (each otherwise satisfying the requirements of paragraph (b)(5)(iii)(A) of this section), and where such substitution is not treated as a modification of the original stock option pursuant to paragraph (b)(5)(v)(D) of this section, both the distributing corporation stock and the subsidiary corporation stock are treated as service recipient stock for purposes of applying this paragraph (b)(5) to the replacement stock options.

(iv) *Determination of the fair market value of service recipient stock—(A) Stock readily tradable on an established securities market.* For purposes of paragraph (b)(5)(i) of this section, in the case of service recipient stock that is readily tradable on an established securities market, the fair market value of the stock may be determined 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, the arithmetic mean of the high and low prices on the trading day before or the trading day of the grant, or any other reasonable method using actual transactions in such stock as reported by such market. The determination of fair market value also may be determined using an average selling price during a specified period that is within 30 days before or 30 days after the applicable valuation date, provided that the program under which the stock right is granted, including a program with a single participant, must irrevocably specify the commitment to grant the stock right with an exercise price set using such an average selling price before the beginning of the specified period. For this purpose, the term *average selling price* refers to the arithmetic mean of such selling prices on all trading days during the specified period, or

the average of such prices over the specified period weighted based on the volume of trading of such stock on each trading day during such specified period. To satisfy this requirement, the service recipient must designate the recipient of the stock right, the number and class of shares of stock that are subject to the stock right, and the method for determining the exercise price including the period over which the averaging will occur, before the beginning of the specified averaging period. Notwithstanding the forgoing provisions of this paragraph (b)(5)(iv)(A), where applicable foreign law requires that a compensatory stock right be priced based upon a specific price averaging method and period, a stock right granted in accordance with such applicable foreign law will be treated as meeting the requirements of this paragraph (b)(5)(iv)(A), provided that the averaging period does not exceed 30 days.

(B) *Stock not readily tradable on an established securities market—(1) In general.* For purposes of paragraph (b)(5)(i) of this section, in the case of service recipient stock that is not readily tradable on an established securities market, the fair market value of the stock as of a valuation date means a value determined by the reasonable application of a reasonable valuation method. The determination whether a valuation method is reasonable, or whether an application of a valuation method is reasonable, is made based on the facts and circumstances as of the valuation date. Factors to be considered under a reasonable valuation method include, as applicable, the value of tangible and intangible assets of the corporation, the present value of anticipated future cash-flows of the corporation, the market value of stock or equity interests in similar corporations and other entities engaged in trades or businesses substantially similar to those engaged in by the corporation the stock of which is to be valued, the value of which can be readily determined through nondiscretionary, objective means (such as through trading prices on an established securities market or an amount paid in an arm's length private transaction), recent arm's length transactions involving the sale or transfer of such stock or equity interests, 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 eco-

conomic effect on the service recipient, its stockholders, or its creditors. The use of a valuation method is not reasonable if such valuation method does not take into consideration in applying its methodology all available information material to the value of the corporation. Similarly, the use of a value previously calculated under a valuation method is not reasonable as of a later date if such calculation fails to reflect information available after the date of the calculation that may materially affect the value of the corporation (for example, the resolution of material litigation or the issuance of a patent) or the value was calculated with respect to a date that is more than 12 months earlier than the date for which the valuation is being used. The service recipient's consistent use of a valuation method to determine the value of its stock or assets for other purposes, including for purposes unrelated to compensation of service providers, is also a factor supporting the reasonableness of such valuation method.

(2) *Presumption of reasonableness.* For purposes of this paragraph (b)(5)(iv)(B), the use of any of the following methods of valuation is presumed to result in a reasonable valuation, provided that the Commissioner may rebut such a presumption upon a showing that either the valuation method or the application of such method was grossly unreasonable:

(i) A valuation of a class of stock determined by an independent appraisal that meets the requirements of section 401(a)(28)(C) and the regulations as of a date that is no more than 12 months before the relevant transaction to which the valuation is applied (for example, the date of grant of a stock option).

(ii) A valuation based upon a formula that, if used as part of a nonlapse restriction (as defined in §1.83-3(h)) with respect to the stock, would be considered to be the fair market value of the stock pursuant to §1.83-5, provided that such stock is valued in the same manner for purposes of any nonlapse restriction applicable to the transfer of any shares of such class of stock (or any substantially similar class of stock) to the issuer or any person that owns stock possessing more than 10 percent of the total combined voting power of all classes of stock of the issuer (applying the stock attribution rules of §1.424-1(d)), other than an arm's length transaction involving the sale

of all or substantially all of the outstanding stock of the issuer, and such valuation method is used consistently for all such purposes, and provided further that this paragraph (b)(5)(iv)(B)(2)(ii) does not apply with respect to stock subject to a stock right payable in stock, where the stock acquired pursuant to the exercise of the stock right is transferable other than through the operation of a nonlapse restriction.

(iii) A valuation, made reasonably and in good faith and evidenced by a written report that takes into account the relevant factors described in paragraph (b)(5)(iv)(B)(1) of this section, of illiquid stock of a start-up corporation. For this purpose, illiquid stock of a start-up corporation means service recipient stock of a corporation that has no material trade or business that it or any predecessor to it has conducted for a period of 10 years or more and has no class of equity securities that are traded on an established securities market (as defined in paragraph (k) of this section), where such stock is not subject to any put, call, or other right or obligation of the service recipient or other person to purchase such stock (other than a right of first refusal upon an offer to purchase by a third party that is unrelated to the service recipient or service provider and other than a right or obligation that constitutes a lapse restriction as defined in §1.83-3(i)), and provided that this paragraph (b)(5)(iv)(B)(2)(iii) does not apply to the valuation of any stock if the service recipient or service provider may reasonably anticipate, as of the time the valuation is applied, that the service recipient will undergo a change in control event as described in §1.409A-3(i)(5)(v) or §1.409A-3(i)(5)(vii) within the 90 days following the action to which the valuation is applied, or make a public offering of securities within the 180 days following the action to which the valuation is applied. For purposes of this paragraph (b)(5)(iv)(B)(2)(iii), a valuation will not be treated as made reasonably and in good faith unless the valuation is performed by a person or persons that the corporation reasonably determines is qualified to perform such a valuation based on the person's or persons' significant knowledge, experience, education, or training. Generally, a person will be qualified to perform such a valuation if a reasonable individual, upon being apprised of such knowledge,

experience, education, and training, would reasonably rely on the advice of such person with respect to valuation in deciding whether to accept an offer to purchase or sell the stock being valued. For this purpose, significant experience generally means at least five years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry in which the service recipient operates.

(3) *Use of alternative methods.* For purposes of this paragraph (b)(5), a different valuation method may be used for each separate action for which a valuation is relevant, provided that a single valuation method is used for each separate action and, once used, may not retroactively be altered. For example, one valuation method may be used to establish the exercise price of a stock option, and a different valuation method may be used to determine the value at the date of the repurchase of stock pursuant to a put or call right. However, once an exercise price or amount to be paid has been established, the exercise price or amount to be paid may not be changed through the retroactive use of another valuation method. In addition, notwithstanding the foregoing, where after the date of grant, but before the date of exercise or transfer, of the stock right, the service recipient stock to which the stock right relates becomes readily tradable on an established securities market, the service recipient must use the valuation method set forth in paragraph (b)(5)(iv)(A) of this section for purposes of determining the payment at the date of exercise or the purchase of the stock, as applicable.

(v) *Modifications, extensions, substitutions, and assumptions of stock rights—(A) Treatment of modified and extended stock rights.* A modification of the terms of a stock right within the meaning of paragraph (b)(5)(v)(B) of this section is considered to be the grant of a new stock right. The new stock right may or may not constitute a deferral of compensation under paragraph (b)(5)(i) of this section, determined at the date of grant of the new stock right. If there is an extension of a stock right (within the meaning of paragraph (b)(5)(v)(C) of this section), the stock right is treated as having had an additional deferral feature from

the original date of grant of the stock right, and therefore will be treated as a plan providing for the deferral of compensation from the original grant date for purposes of this paragraph (b).

(B) *Modification in general.* Except as otherwise provided in paragraph (b)(5)(v) of this section, the term *modification* means any change in the terms of the stock right (or change in the terms of the plan pursuant to which the stock right was granted or in the terms of any other agreement governing the stock right) that may provide the holder of the stock right with a direct or indirect reduction in the exercise price of the stock right regardless of whether the holder in fact benefits from the change in terms. A change in the terms of the stock right shortening the period during which the stock right is exercisable is not a modification. It is not a modification to add a feature providing the ability to tender previously acquired stock for the stock purchasable under the stock right, or to withhold or have withheld shares of stock to facilitate the payment of the exercise price or the employment taxes or required withholding taxes resulting from the exercise of the stock right. In addition, it is not a modification for the grantor to exercise discretion specifically reserved under a stock right with respect to the transferability of the stock right.

(C) *Extensions—(1) In general.* An extension of a stock right refers to the provision to the holder of an additional period of time within which to exercise the stock right beyond the time originally prescribed under the terms of the stock right, the conversion or exchange of a stock right for a legally binding right to compensation in a future taxable year, or the addition of any feature for the deferral of compensation not permitted in paragraph (b)(5)(i)(A)(3) of this section (in the case of a stock option) or not permitted in paragraph (b)(5)(i)(B)(3) of this section (in the case of a stock appreciation right) to the terms of the stock right, other than at a time when the exercise price of the stock right equals or exceeds the fair market value of the service recipient stock that could be purchased (in the case of an option) or the fair market value of the service recipient stock used to determine the payment to the service provider (in the case of a stock appreciation right), and includes a renewal of such right that has such effect. It is not an

extension if the exercise period of a stock right is extended to a date no later than the earlier of the latest date upon which the stock right could have expired by its original terms under any circumstances or the 10th anniversary of the original date of grant of the stock right. If the exercise period of a stock right is extended at a time when the exercise price of the stock right equals or exceeds the fair market value of the service recipient stock that could be purchased (in the case of an option) or the fair market value of the service recipient stock used to determine the payment to the service provider (in the case of a stock appreciation right), it is not an extension of the original stock right. Instead, in such a case, the original stock right is treated as modified rather than extended and a new stock right is treated as having been granted for purposes of this section. In addition, it is not an extension of a stock right if the expiration of the stock right is tolled while the holder cannot exercise the stock right because such an exercise would violate an applicable Federal, state, local, or foreign law, or would jeopardize the ability of the service recipient to continue as a going concern, provided that the period during which the stock right may be exercised is not extended more than 30 days after the exercise of the stock right first would no longer violate an applicable Federal, state, local, and foreign laws or would first no longer jeopardize the ability of the service recipient to continue as a going concern. For this purpose, a provision of foreign law shall be considered applicable only to foreign earned income (as defined under section 911(b)(1) without regard to section 911(b)(1)(B)(iv) and without regard to the requirement that the income be attributable to services performed during the period described in section 911(d)(1)(A) or (B)) from sources within the foreign country that promulgated such law.

(2) *Certain extensions before April 10, 2007.* An extension of a stock right before April 10, 2007, solely in order to provide the holder of such stock right an additional period of time beyond the time originally prescribed under the terms of such stock right within which to exercise the stock right is disregarded for purposes of applying the rules contained in paragraph (b)(5)(v)(C)(1) of this section. For purposes of applying the rules contained in paragraph (b)(5)(v)(C)(1) of this section

on and after April 10, 2007, such a stock right is treated as having specified at the date of grant the time within which to exercise such stock right that was prescribed under the terms of such stock right in effect on April 9, 2007. Nothing in this paragraph (b)(5)(v)(C)(2) affects any other action treated as the extension of a stock right, including the addition of a deferral feature.

(3) *Examples.* The following examples illustrate the provisions of this paragraph (b)(5)(v)(C). In the examples, each employee is an individual employed by the specified employer, and each employee and each employer has a calendar year taxable year.

Example 1. On July 1, 2009, Employer Z grants Employee A a nonstatutory stock option that does not provide for the deferral of compensation in accordance with paragraph (b)(5)(i)(A) of this section. The terms of the nonstatutory stock option provide that the exercise period of the stock option expires on the earlier of July 1, 2019, or 3 months after Employee A's separation from service. On July 1, 2011, Employee A separates from service. On the same day, Employee A and Employer Z change the exercise period of the option so that it expires on July 1, 2013. Because the exercise period of the stock right is not extended beyond July 1, 2019, the change is not an extension for purposes of this paragraph (b)(5)(v)(C).

Example 2. The facts are the same as in *Example 1* except that Employee A separates from service on July 1, 2018, and on the same day, Employee A and Employer Z change the exercise period of the option so that it expires on July 1, 2020. As of July 1, 2018, the fair market value of the underlying stock exceeds the exercise price. Because the exercise period of the stock right is extended beyond July 1, 2019, the change is an extension for purposes of this paragraph (b)(5)(v)(C).

Example 3. The facts are the same as in *Example 2* except that as of July 1, 2018, the fair market value of the underlying stock is less than the exercise price of the option. Because the exercise period of the stock right is extended at a time when the fair market value of the underlying stock is less than the exercise price, the change is not an extension for purposes of this paragraph (b)(5)(v)(C) and the change is treated as a modification of the option, resulting in the extension of the exercise period being treated as the grant of a new option on July 1, 2018.

Example 4. On July 1, 2009, Employer Y grants to Employee B a stock appreciation right with respect to 200 shares of Employer Y common stock that does not provide for the deferral of compensation in accordance with paragraph (b)(5)(i)(B) of this section. Upon exercise of the stock appreciation right, Employee B is entitled to receive the excess of the fair market value of a share of Employer Y common stock on the date of exercise over \$100 (the fair market value of a share of Employer Y common stock on July 1, 2009), multiplied by the number of shares with respect to which Employee B is exercising the right. The exercise period of the right expires on the earlier of July 1, 2019, or 3 months after Employee B

separates from service. Employee B cannot exercise the stock appreciation right with respect to more than 100 shares unless Employee B continues to be employed by Employer Y through June 30, 2014. On July 1, 2011, when the fair market value of a share of Employer Y common stock is \$200, Employee B and Employer Y amend the stock appreciation right to provide that the right will be exercisable only during calendar year 2018, except that before January 1, 2017, Employee B may elect to designate calendar year 2023 or any subsequent calendar year before 2033 as the year in which the right will be exercisable. The amendment constitutes an extension of the stock appreciation right under paragraph (b)(5)(v)(C)(I) of this section. Under paragraph (b)(5)(v)(A) of this section, the stock appreciation right is treated as having had an additional deferral feature from the original date of grant (July 1, 2009) of the right, and therefore is treated as a plan providing for the deferral of compensation from that date. During the period from July 1, 2009, through June 30, 2011, the provisions of the stock appreciation right relating to the time and form of payment did not satisfy the requirements of §1.409A-3(a). Therefore, the stock appreciation right provides for a deferral of compensation that does not comply with section 409A.

(D) *Substitutions and assumptions of stock rights by reason of a corporate transaction.* If the requirements of §1.424-1 (without regard to the requirement described in §1.424-1(a)(2) that an eligible corporation be the employer of the optionee) would be met if the stock right were a statutory option, the substitution of a new stock right pursuant to a corporate transaction (as defined in §1.424-1(a)(3)) for an outstanding stock right or the assumption of an outstanding stock right pursuant to a corporate transaction will not be treated as the grant of a new stock right or a change in the form of payment for purposes of this section and §§1.409A-2 through 1.409A-6. For purposes of the preceding sentence, the requirement of §1.424-1(a)(5)(iii) will be deemed to be satisfied if the ratio of the exercise price to the fair market value of the shares subject to the stock right immediately after the substitution or assumption is not greater than the ratio of the exercise price to the fair market value of the shares subject to the stock right immediately before the substitution or assumption. In the case of a transaction described in section 355 in which the stock of the distributing corporation and the stock distributed in the transaction are both readily tradable on an established securities market immediately after the transaction, for purposes of this paragraph (b)(5)(v), the requirements of §1.424-1(a)(5) related to the fair market value of the stock may be satisfied by—

(J) Using the last sale before or the first sale after the specified date as of which such valuation is being made, the closing price on the last trading day before or the trading day of a specified date, the arithmetic mean of the high and low prices on the last trading day before or the trading day of such specified date, or any other reasonable method using actual transactions in such stock as reported by such market on a specified date, for the stock of the distributing corporation and the stock distributed in the transaction, provided the specified date is designated before such specified date, and such specified date is not more than 60 days after the transaction;

(2) Using the arithmetic mean of such market prices on trading days during a specified period designated before the beginning of such specified period, where such specified period is not longer than 30 days and ends no later than 60 days after the transaction; or

(3) Using an average of such prices during such prespecified period weighted based on the volume of trading of such stock on each trading day during such prespecified period.

(E) *Acceleration of date when exercisable.* Although with respect to a stock right not immediately exercisable in full, a change in the terms of the right solely to accelerate or delay, within the original term of the stock right, the time at which the stock right (or any portion of such stock right) may be exercised is not a modification for purposes of this section, with respect to a stock right subject to section 409A, such an acceleration may constitute an impermissible acceleration of a payment date under §1.409A-3(j) or a subsequent deferral under §1.409A-2(b).

(F) *Discretionary added benefits.* If a change to a stock right provides, either by its terms or in substance, that the holder may receive an additional benefit under the stock right at the future discretion of the grantor, and the addition of such benefit would constitute a modification or extension, then the addition of such discretion is a modification or extension at the time that the stock right is changed to provide such discretion.

(G) *Change in underlying stock increasing value.* A change in the terms of the stock subject to a stock right that increases the value of the stock is a modification of such stock right, except to

the extent that a new stock right is substituted for such stock right by reason of the change in the terms of the stock in accordance with paragraph (b)(5)(v)(D) of this section.

(H) *Change in the number of shares purchasable.* If a stock right is amended solely to increase the number of shares subject to the stock right, the increase is not considered a modification of the stock right but is treated as the grant of a new additional stock right to which the additional shares are subject. Notwithstanding the previous sentence, if the exercise price and number of shares subject to a stock right are proportionally adjusted to reflect a stock split (including a reverse stock split) or stock dividend, and the only effect of the stock split or stock dividend is to increase (or decrease) on a *pro rata* basis the number of shares owned by each shareholder of the class of stock subject to the stock right, then there is no modification of the stock right if it is proportionally adjusted to reflect the stock split or stock dividend and the aggregate exercise price of the stock right is not less than the aggregate exercise price before the stock split or stock dividend.

(I) *Rescission of changes.* A change to the terms of a stock right (or change in the terms of the plan pursuant to which the stock right was granted or in the terms of any other agreement governing the right) is not considered a modification or extension of the stock right to the extent the change in the terms of the stock right is rescinded by the earlier of the date the stock right is exercised or the last day of the service provider's taxable year during which such change occurred. Thus, for example, if the terms of a stock right granted to an individual employee with a calendar year taxable year are changed on March 1 in a manner that would result in an extension of the stock right, and the change is rescinded on November 1 of the same year, and the stock right is not exercised before the change is rescinded, the stock right is not considered extended under this paragraph (b)(5)(v).

(J) *Successive modifications and extensions.* The rules of this paragraph (b)(5)(v) apply as well to successive modifications and extensions.

(K) *Modifications and extensions in effect on October 23, 2004.* For purposes of the application of section 409A and these

regulations to a stock right, if a legally binding right to a modification or extension of such stock right existed on October 23, 2004, such modification or extension is disregarded, and the stock right is treated as if granted with the terms and conditions in effect on October 23, 2004.

(vi) *Meaning and use of certain terms*—(A) *Option*. The term *option* means the right or privilege of an individual to purchase stock from a corporation by virtue of an offer of the corporation continuing for a stated period of time, whether or not irrevocable, to sell such stock at a price determined under paragraph (b)(5)(vi)(D) of this section, such individual being under no obligation to purchase. While no particular form of words is necessary, the option must express an offer to sell at the option price, the maximum number of shares purchasable under the option, and the period of time during which the offer remains open. The term *option* includes a warrant that meets the requirements of this paragraph (b)(5)(vi)(A). An option may be granted as part of or in conjunction with an employee stock purchase plan or subscription contract. An option must be in writing (in paper or electronic form) provided that such writing is adequate to establish an option right or privilege that is enforceable under applicable law.

(B) *Date of grant of option*. (1) The language the *date of grant of the option*, and similar phrases, refer to the date when the granting corporation completes the corporate action necessary to create the legally binding right constituting the option. A corporate action creating the legally binding right constituting the option is not considered complete until the date on which the maximum number of shares that can be purchased under the option and the minimum exercise price are fixed or determinable, and the class of underlying stock and the identity of the service provider is designated. Ordinarily, if the corporate action provides for an immediate offer of stock for sale to a service provider, or provides for a particular date on which such offer is to be made, the date of the granting of the option is the date of such corporate action if the offer is to be made immediately, or the date provided as the date of the offer, as the case may be. However, an unreasonable delay in the giving of notice of such offer to the service provider will be taken into account as indicating that the

corporation provided that the offer was to be made at the subsequent date on which such notice is given.

(2) If the corporation imposes a condition on the granting of an option (as distinguished from a condition governing the exercise of the option), such condition generally will be given effect in accordance with the intent of the corporation. However, if the grant of an option is subject to approval by stockholders, the date of grant of the option will be determined as if the option had not been subject to such approval. A condition that does not require corporate action, such as the approval of, or registration with, some regulatory or government agency, for example, a stock exchange or the Securities and Exchange Commission, is ordinarily considered a condition upon the exercise of the option unless the corporate action clearly indicates that the option is not to be granted until such condition has been satisfied.

(3) In general, a condition imposed upon the exercise of an option will not operate to make ineffective the granting of the option. For example, on June 1, 2008, Corporation A grants to X, an employee, an option to purchase 5,000 shares of the corporation's common stock, exercisable by X on or after June 1, 2009, provided X is employed by the corporation on June 1, 2009, and provided that A's profits during the fiscal year preceding the year of exercise exceed \$200,000. Such an option is granted to X on June 1, 2008, and will be treated as outstanding as of such date.

(C) *Stock*. The term *stock* means capital stock of any class, including voting or nonvoting common or preferred stock. Except as otherwise provided, the term *stock* includes both treasury stock and stock of original issue. Special classes of stock authorized to be issued to and held by employees are within the scope of the term *stock* for this purpose, provided such stock otherwise possesses the rights and characteristics of capital stock.

(D) *Exercise price*. The term *exercise price* means the consideration in cash or property that, pursuant to the terms of the option, is the price at which the stock subject to the option is purchased. The term *exercise price* does not include any amounts paid as interest under a deferred payment plan or treated as interest.

(E) *Exercise*. The term *exercise*, when used in reference to an option, means the

act of acceptance by the holder of the option of the offer to sell contained in the option. In general, the time of exercise is the time when there is a sale or a contract to sell between the corporation and the individual. A promise to pay the exercise price does not constitute an exercise of the option unless the holder of the option is subject to personal liability on such promise. An agreement or undertaking by the service provider to make payments under a stock purchase plan does not constitute the exercise of an option to the extent the payments made remain subject to withdrawal by or refund to the service provider.

(F) *Transfer*. The term *transfer*, when used in reference to the transfer to an individual of a share of stock pursuant to the exercise of an option, means the transfer of ownership of such share, or the transfer of substantially all the rights of ownership. Such transfer must, within a reasonable time, be evidenced on the books of the corporation. A transfer may occur even if a share of stock is subject to a substantial risk of forfeiture or is not otherwise transferable immediately after the date of exercise. A transfer does not fail to occur merely because, under the terms of the arrangement, the individual may not dispose of the share for a specified period of time, or the share is subject to a right of first refusal or a right to acquire the share at the share's fair market value at the time of the sale.

(G) *Readily tradable*. For purposes of this section and §§1.409A-2 through 1.409A-6, stock is treated as readily tradable if it is regularly quoted by brokers or dealers making a market in such stock.

(H) *Application to stock appreciation rights*. For purposes of this section and §§1.409A-2 through 1.409A-6, the definitions provided in paragraphs (b)(5)(vi)(A) through (G) of this section may be applied by analogy to the issuance of, exercise of, or payment upon the exercise of, a stock appreciation right.

(6) *Restricted property, section 402(b) trusts, and section 403(c) annuities*—(i) *In general*. If a service provider receives property from, or pursuant to, a plan maintained by a service recipient, there is no deferral of compensation merely because the value of the property is not includible in income by reason of the property being substantially nonvested (as defined in §1.83-3(b)), or is includible in income

solely due to a valid election under section 83(b). For purposes of this paragraph (b)(6)(i), a transfer of property includes the transfer of a beneficial interest in a trust or annuity plan, or a transfer to or from a trust or under an annuity plan, to the extent such a transfer is subject to section 83, section 402(b) or section 403(c). In addition, for purposes of this paragraph (b), a right to compensation income that will be required to be included in income under section 402(b)(4)(A) is not a deferral of compensation.

(ii) *Promises to transfer property.* A plan under which a service provider obtains a legally binding right to receive property in a future taxable year where the property will be substantially vested (as defined in §1.83-3(b)) at the time of transfer of the property may provide for the deferral of compensation and, accordingly, may constitute a nonqualified deferred compensation plan. A legally binding right to receive property in a future taxable year where the property will be substantially nonvested (as defined in §1.83-3(b)) at the time of transfer of the property will not provide for the deferral of compensation and, accordingly, will not constitute a nonqualified deferred compensation plan unless offered in conjunction with another legally binding right that constitutes a deferral of compensation.

(7) *Arrangements between partnerships and partners.* [Reserved.]

(8) *Certain foreign plans—(i) Plans with respect to compensation covered by treaty or other international agreement.* A plan in which a service provider participates does not provide for a deferral of compensation for purposes of this paragraph (b) to the extent that the compensation under the plan would have been excluded from gross income for Federal income tax purposes under the provisions of any bilateral income tax convention or other bilateral or multilateral agreement to which the United States is a party if the compensation had been paid to the service provider at the time that the legally binding right to the compensation first arose or, if later, the time that the legally binding right was no longer subject to a substantial risk of forfeiture.

(ii) *Plans with respect to certain other compensation.* A plan in which a service provider participates does not provide for

a deferral of compensation for purposes of this paragraph (b) to the extent that compensation under the plan would not have been includible in gross income for Federal tax purposes if it had been paid to the service provider at the time that the legally binding right to the compensation first arose or, if later, the time that the legally binding right was no longer subject to a substantial risk of forfeiture, due to one of the following:

(A) The service provider was a nonresident alien at such time and the compensation would not have been includible in gross income under section 872.

(B) The service provider was a qualified individual (as defined in section 911(d)(1)) at such time, the compensation would have been foreign earned income within the meaning of section 911(b)(1) (without regard to section 911(b)(1)(B)(iv)) if paid at such time, and the amount of such compensation was equal to or less than the excess (if any) of the maximum exclusion amount under section 911(b)(2)(D) for such taxable year over the amount of foreign earned income actually excluded from gross income by such qualified individual for such taxable year under section 911(a)(1).

(C) The compensation would have been excludible from gross income under section 893.

(D) The compensation would have been excludible from gross income under section 931 or section 933.

(iii) *Tax equalization agreements.* A tax equalization agreement does not provide for a deferral of compensation if payments made under such tax equalization agreement are made no later than the end of the second taxable year of the service provider beginning after the taxable year of the service provider in which the service provider's U.S. Federal income tax return is required to be filed (including any extensions) for the year to which the compensation subject to the tax equalization payment relates, or, if later, the second taxable year of the service provider beginning after the latest such taxable year in which the service provider's foreign tax return or payment is required to be filed or made for the year to which the compensation subject to the tax equalization payment relates. Where such payments arise due to an audit, litigation or similar proceeding, the right to the payments will not

be treated as resulting in a deferral of compensation if the payments are scheduled and made in accordance with the provisions of §1.409A-3(i)(1)(v) (timing of tax gross-up payments). For purposes of this paragraph (b)(8)(iii), the term *tax equalization agreement* refers to an agreement, method, program, or other arrangement that provides payments intended to compensate the service provider for some or all of the excess of the taxes actually imposed by a foreign jurisdiction on the compensation paid by the service recipient to the service provider over the taxes that would be imposed if the compensation were subject solely to United States Federal, state, and local income tax, or some or all of the excess of the United States Federal, state, and local income tax actually imposed on the compensation paid by the service to the service provider over the taxes that would be imposed if the compensation were subject solely to taxes in the foreign jurisdiction, provided that the payment made under such agreement, method, program, or other arrangement may not exceed such excess and the amount necessary to compensate for the additional taxes on the amount paid under the agreement, method, program, or other arrangement.

(iv) *Certain limited deferrals of a nonresident alien.* With respect to a nonresident alien, a foreign plan does not provide for a deferral of compensation if the amounts deferred under the foreign plan based upon services performed by the nonresident alien in the United States (including amounts deferred based upon service credits or compensation received due to services performed in the United States) do not exceed the applicable dollar amount under section 402(g)(1)(B) for the taxable year. If the amounts deferred under the foreign plan based upon the services performed by the nonresident alien in the United States exceed the applicable dollar amount, an amount of such deferrals equal to such amount is treated as not deferred under a nonqualified deferred compensation plan. For purposes of this paragraph (b)(8)(iv), the term *foreign plan* means a plan that, together with all substantially similar plans, is maintained by a service recipient for a substantial number of participants, substantially all of whom are nonresident aliens or resident aliens classified as resident aliens solely under

section 7701(b)(1)(A)(ii) (and not section 7701(b)(1)(A)(i)).

(v) *Additional foreign plans.* A plan in which a service provider participates does not provide for a deferral of compensation for purposes of this paragraph (b) to the extent designated by the Commissioner in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(vi) *Earnings.* Earnings on compensation excluded from the definition of deferral of compensation pursuant to this paragraph (b)(8) are also not treated as a deferral of compensation.

(9) *Separation pay plans*—(i) *In general.* A plan that otherwise provides for a deferral of compensation under this paragraph (b) does not fail to provide a deferral of compensation merely because the right to payment of the compensation is conditioned upon a separation from service. However, paragraphs (b)(9)(ii), (iii), (iv), and (v) of this section provide rules concerning the extent to which certain separation pay plans do not provide for the deferral of compensation. The exceptions contained in paragraphs (b)(9)(ii), (iii), (iv), and (v) of this section may be used in combination, such that compensation under a plan that would be excepted under one of those paragraphs may be treated as excepted under another of those paragraphs, so that other compensation under a plan may be treated as excepted under the first of such paragraphs. Notwithstanding any other provision of this paragraph (b)(9), any payment or benefit, or entitlement to a payment or benefit, that acts as a substitute for, or replacement of, amounts deferred by the service recipient under a separate nonqualified deferred compensation plan constitutes a payment or a deferral of compensation under the separate nonqualified deferred compensation plan, and does not constitute a payment or deferral of compensation under a separation pay plan. If a service provider receives a payment at separation from service and also has a legally binding right to an amount of deferred compensation that would be forfeited upon the separation from service, whether the payment acts as an acceleration of vesting and substitute payment for the amount of deferred compensation forfeited, or whether the deferred compensation is treated as forfeited and the amount

paid is treated as a separate payment of current compensation, is determined based on the facts and circumstances, provided that, where the separation from service is voluntary, it is presumed that the payment results from an acceleration of vesting followed by a payment of the deferred compensation that is subject to section 409A. Accordingly, any change in the payment schedule to accelerate or defer the payments would be subject to the rules of section 409A. The presumption that a right to a payment is not a new right, but is instead a right substituted for a pre-existing forfeited right, may be rebutted by demonstrating that the service provider would have obtained the right to the payment regardless of the forfeiture of the nonvested right. A factor indicating that the service provider would have obtained a right to a payment regardless of the forfeiture of the nonvested right is that the amount to which the service provider obtains a right is materially less than an amount equal to the present value of the forfeited amount multiplied by a fraction, the numerator of which is the period of service the service provider actually completed, and the denominator of which is the full period of service the service provider would have been required to complete to receive the full amount of the payment. For example, where a service provider is entitled to a future payment only if the service provider completes three years of service and at the time of termination the service provider has completed one year of service, the presumption could be rebutted if the payment to the service provider is materially less than the present value of one-third of the nonvested amount. Another such factor is that the payment to the service provider is of a type customarily made to service providers who separate from service with the service recipient and do not forfeit nonvested rights to deferred compensation (for example, a payment of accrued but unused leave or a payment for a release of actual or potential claims).

(ii) *Collectively bargained separation pay plans.* A separation pay plan does not provide for a deferral of compensation to the extent the plan is a collectively bargained separation pay plan that provides for separation pay only upon an involuntary separation from service or pursuant to a window program. Only the portion of the separation pay plan attributable to employ-

ees covered by a *bona fide* collective bargaining agreement is considered to be provided under a collectively bargained separation pay plan. A collectively bargained separation pay plan is a separation pay plan that meets the following conditions:

(A) The separation pay plan is contained within an agreement that the Secretary of Labor determines to be a collective bargaining agreement.

(B) The separation pay provided by the collective bargaining agreement was the subject of arm's length negotiations between employee representatives and one or more employers, and the agreement between employee representatives and one or more employers satisfies section 7701(a)(46).

(C) The circumstances surrounding the agreement evidence good faith bargaining between adverse parties over the separation pay to be provided under the agreement.

(iii) *Separation pay due to involuntary separation from service or participation in a window program.* A separation pay plan that is not described in paragraph (b)(9)(ii) of this section and that provides for separation pay only upon an involuntary separation from service (as defined in paragraph (n) of this section) or pursuant to a window program does not provide for a deferral of compensation to the extent that the separation pay, or portion of the separation pay, provided under the plan meets the following requirements:

(A) The separation pay (other than amounts described in paragraphs (b)(9)(iv) and (v) of this section) does not exceed two times the lesser of—

(1) The sum of the service provider's annualized compensation based upon the annual rate of pay for services provided to the service recipient for the taxable year of the service provider preceding the taxable year of the service provider in which the service provider has a separation from service with such service recipient (adjusted for any increase during that year that was expected to continue indefinitely if the service provider had not separated from service); or

(2) The maximum amount that may be taken into account under a qualified plan pursuant to section 401(a)(17) for the year in which the service provider has a separation from service.

(B) The plan provides that the separation pay described in paragraph (b)(9)(iii)(A) of this section must be paid no later than the last day of the second taxable year of the service provider following the taxable year of the service provider in which occurs the separation from service.

(iv) *Foreign separation pay plans.* A separation pay plan (including a plan providing payments upon a voluntary separation from service) does not provide for deferred compensation to the extent the plan provides for amounts of separation pay required to be provided under the applicable law of a foreign jurisdiction. For this purpose, a provision of foreign law shall be considered applicable only to foreign earned income (as defined under section 911(b)(1) without regard to section 911(b)(1)(B)(iv) and without regard to the requirement that the income be attributable to services performed during the period described in section 911(d)(1)(A) or (B)) from sources within the foreign country that promulgated such law.

(v) *Reimbursements and certain other separation payments—(A) In general.* To the extent a separation pay plan (including a plan providing payments upon a voluntary separation from service) entitles a service provider to payment by the service recipient of reimbursements that are not otherwise excludible from gross income, for expenses that the service provider could otherwise deduct under section 162 or section 167 as business expenses incurred in connection with the performance of services (ignoring any applicable limitation based on adjusted gross income), or of reasonable outplacement expenses and reasonable moving expenses actually incurred by the service provider and directly related to the termination of services for the service recipient, such plan does not provide for a deferral of compensation to the extent such rights apply during a limited period of time (regardless of whether such rights extend beyond the limited period of time). For purposes of this paragraph (b)(9)(v)(A), the reimbursement of reasonable moving expenses includes the reimbursement of all or part of any loss the service provider actually incurs due to the sale of a primary residence in connection with a separation from service.

(B) *Medical benefits.* To the extent a separation pay plan (including a plan providing payments due to a voluntary

separation from service) entitles a service provider to reimbursement by the service recipient of payments of medical expenses incurred and paid by the service provider but not reimbursed by a person other than the service recipient and allowable as a deduction under section 213 (disregarding the requirement of section 213(a) that the deduction is available only to the extent that such expenses exceed 7.5 percent of adjusted gross income), such plan does not provide for a deferral of compensation to the extent such rights apply during the period of time during which the service provider would be entitled (or would, but for such plan, be entitled) to continuation coverage under a group health plan of the service recipient under section 4980B (COBRA) if the service provider elected such coverage and paid the applicable premiums.

(C) *In-kind benefits and direct service recipient payments.* A service provider's entitlement to in-kind benefits from the service recipient, or a payment by the service recipient directly to the person providing the goods or services to the service provider, is treated as not providing for a deferral of compensation for purposes of this paragraph (b), if a right to reimbursement by the service recipient for a payment for such benefits, goods, or services by the service provider would not be treated as providing for a deferral of compensation under this paragraph (b)(9)(v).

(D) *Limited payments.* If not otherwise excluded, a taxpayer may treat a right or rights under a separation pay plan to a payment or payments as not providing for a deferral of compensation to the extent such payments in the aggregate do not exceed the applicable dollar amount under section 402(g)(1)(B) for the year of the separation from service.

(E) *Limited period of time.* For purposes of paragraphs (b)(9)(v)(A) and (C) of this section, a limited period of time in which expenses may be incurred, or in-which in-kind benefits may be provided by the service recipient or a third party that the service recipient will pay, does not include periods beyond the last day of the second taxable year of the service provider following the taxable year of the service provider in which the separation from service occurred, provided that the period during which the reimbursements for such expenses must be paid may not

extend beyond the third taxable year of the service provider following the taxable year of the service provider in which the separation from service occurred.

(vi) *Window programs — definition.* The term *window program* refers to a program established by a service recipient in connection with an impending separation from service to provide separation pay, where such program is made available by the service recipient for a limited period of time (no longer than 12 months) to service providers who separate from service during that period or to service providers who separate from service during that period under specified circumstances. A program will not be considered a window program if a service recipient establishes a pattern of repeatedly providing for similar separation pay in similar situations for substantially consecutive, limited periods of time. Whether the recurrence of these programs constitutes a pattern is determined based on the facts and circumstances. Although no one factor is determinative, relevant factors include whether the benefits are on account of a specific business event or condition, the degree to which the separation pay relates to the event or condition, and whether the event or condition is temporary or discrete or is a permanent aspect of the employer's business.

(10) *Certain indemnification and liability insurance plans.* A plan in which a service provider participates does not provide for a deferral of compensation for purposes of this paragraph (b) to the extent that the plan provides (to the extent permissible under applicable law), for the indemnification of, or the purchase of an insurance policy providing for payments of, all or part of the expenses incurred or damages paid or payable by a service provider with respect to a *bona fide* claim against the service provider or service recipient, including amounts paid or payable by the service provider upon the settlement of a *bona fide* claim against the service provider or service recipient, where such claim is based on actions or failures to act by the service provider in his or her capacity as a service provider of the service recipient.

(11) *Legal settlements.* An agreement to which a service provider is a party does not provide for a deferral of compensation for purposes of this paragraph (b) to the extent that the agreement provides for

amounts paid as settlements or awards resolving *bona fide* legal claims based on wrongful termination, employment discrimination, the Fair Labor Standards Act, or worker's compensation statutes, including claims under applicable Federal, state, local, or foreign laws, or for reimbursements or payments of reasonable attorneys fees or other reasonable expenses incurred by the service provider related to such *bona fide* legal claims, regardless of whether such settlements, awards, or reimbursement or payment of expenses pursuant to such claims are treated as compensation or wages for Federal tax purposes. Whether the execution of a waiver of any or all of such types of claims indicates that the amounts are paid as an award or settlement of an actual *bona fide* claim for damages under applicable law is determined based on the facts and circumstances. This paragraph (b)(11) does not apply to any deferred amounts that did not arise as a result of an actual *bona fide* claim for damages under applicable law, such as amounts that would have been deferred or paid regardless of the existence of such claim, even if such amounts are paid or modified as part of a settlement or award resolving an actual *bona fide* claim. For this purpose, a provision of foreign law shall be considered applicable only to foreign earned income (as defined under section 911(b)(1) without regard to section 911(b)(1)(B)(iv) and without regard to the requirement that the income be attributable to services performed during the period described in section 911(d)(1)(A) or (B)) from sources within the foreign country that promulgated such law.

(12) *Certain educational benefits.* A plan in which a service provider participates does not provide for a deferral of compensation to the extent the plan provides for taxable educational benefits. For purposes of this paragraph (b)(12), the term *educational benefits* refers solely to benefits provided to a service provider, consisting solely of educational assistance for the education of the service provider, as defined in section 127(c) and the accompanying regulations, and does not refer to any benefits provided for the education of any other person, including any spouse, child, or other family member of the service provider.

(c) *Plan*—(1) *In general.* The term *plan* includes any agreement, method, program, or other arrangement, including an agreement, method, program, or other arrangement that applies to one person or individual. A plan may be adopted unilaterally by the service recipient or may be negotiated or agreed to by the service recipient and one or more service providers or service provider representatives. An agreement, method, program, or other arrangement may constitute a plan regardless of whether it is an employee benefit plan under section 3(3) of ERISA, as amended (29 U.S.C. 1002(3)). The requirements of section 409A are applied as if a separate plan or plans is maintained for each service provider. For purposes of determining the terms of a plan, general provisions of the plan that purport to nullify noncompliant plan terms, or to supply any specific plan terms required by this section, §1.409A-2 or §1.409A-3, are disregarded.

(2) *Plan aggregation rules*—(i) *In general.* Except as otherwise provided, the following rules apply with respect to the application of this section and §§1.409A-2 through 1.409A-6 to deferrals of compensation with respect to a service provider:

(A) All deferrals of compensation at the election of that service provider under all plans of the service recipient that are account balance plans, except to the extent that the plan is described in paragraph (c)(2)(i)(D), (E), (F), (G), or (H) of this section, are treated as deferred under a single plan. For purposes of this paragraph, the term *account balance plan* means—

(1) An agreement, method, program, or other arrangement that is an account balance plan as defined in §31.3121(v)(2)-1(c)(1)(ii)(A) of this chapter, including mandatorily bifurcating the agreement, method, program, or other arrangement in accordance with the rules provided in §31.3121(v)-1(c)(1)(iii)(B) of this chapter; or

(2) An agreement, method, program, or other arrangement that would be described in paragraph (c)(2)(i)(A)(1) of this section if the service provider were an employee.

(B) All deferrals of compensation other than at the election of that service provider, including deferrals reflecting matching by the service recipient with respect to amounts a service provider elects to defer, under all plans of the service recipient that are account balance plans,

except to the extent the plan is described in paragraph (c)(2)(i)(D), (E), (F), (G), or (H) of this section, are treated as deferred under a single plan. For purposes of this paragraph (c)(2)(i)(B), the term “account balance plan” has the same meaning as provided in paragraph (c)(2)(i)(A) of this section.

(C) All deferrals of compensation with respect to that service provider under all plans of the service recipient that are nonaccount balance plans, except to the extent such plan is described in paragraph (c)(2)(i)(D), (E), (F), (G), or (H) of this section, are treated as deferred under a single plan. For purposes of this paragraph (c)(2)(i)(C), the term *nonaccount balance plan* means—

(1) An agreement, method, program, or other arrangement that is a nonaccount balance plan as defined in §31.3121(v)(2)-1(c)(2)(i) of this chapter, including mandatorily bifurcating the agreement, method, program, or other arrangement in accordance with the rules provided in §31.3121(v)-1(c)(1)(iii)(B) of this chapter; or

(2) An agreement, method, program, or other arrangement that would be described in paragraph (c)(2)(i)(C)(1) of this section if the service provider were an employee.

(D) All deferrals of compensation with respect to that service provider under all separation pay plans (as defined in paragraph (m) of this section) of the service recipient to the extent an amount deferred under the plans is not described in paragraph (c)(2)(i)(E) of this section and is payable solely upon an involuntary separation from service within the meaning of paragraph (n) of this section or as a result of participation in a window program, are treated as deferred under a single plan.

(E) All deferrals of compensation with respect to that service provider under all plans of the service recipient to the extent such amounts deferred consist of rights to in-kind benefits or reimbursements of expenses, such as membership fees, or expenses related to aircraft or vehicle usage, to the extent that the right to the in-kind benefit or reimbursement, separately or in the aggregate, does not constitute a substantial portion of either the overall compensation earned by the service provider for performing services for the service recipient or the overall compensation received due to a separation

from service, are treated as deferred under a single plan.

(F) All deferrals of compensation with respect to that service provider under all plans of the service recipient to the extent that the taxation of such compensation is governed by §1.61-22 or §1.7872-15 (split-dollar life insurance arrangements), or the taxation of such compensation would be governed by §1.61-22 or §1.7872-15 but for the operation of §1.61-22(j) (effective date provisions), are treated as deferred under a single plan.

(G) All deferrals of compensation with respect to that service provider under all agreements, methods, programs, or other arrangements of the service recipient to the extent the deferrals under the agreements, methods, programs, or other arrangements are deferrals of amounts that would be treated as modified foreign earned income (meaning foreign earned income as defined under section 911(b)(1) without regard to section 911(b)(1)(B)(iv) and without regard to the requirement that the income be attributable to services performed during the period described in section 911(d)(1)(A) or (B)) if paid to the service provider at the time the amount is first deferred, and provided further that substantially all the participants in such agreements, methods, programs, or other arrangements and any substantially similar agreements, methods, programs, or other arrangements are nonresident aliens and that the service provider does not participate in a substantially identical agreement, method, program, or other arrangement that does not meet the requirements of this paragraph (c)(2)(i)(G) (a domestic arrangement), are treated as deferred under a single plan.

(H) All deferrals of compensation with respect to that service provider under all plans of the service provider to the extent such plans are stock rights (as defined in paragraph (I) of this section) subject to section 409A, are treated as deferred under a single plan.

(I) All deferrals of compensation with respect to that service provider under all plans of the service recipient to the extent such plans are not described in paragraph (c)(2)(i)(A), (B), (C), (D), (E), (F), (G), or (H) of this section are treated as deferred under a single plan.

(ii) *Dual status.* Agreements, methods, programs, and other arrangements

in which a service provider participates are not aggregated with other agreements, methods, programs, and other arrangements to the extent the service provider participates in one set of agreements, methods, programs, and other arrangements due to status as an employee of the service recipient (employee arrangements) and another set of agreements, methods, programs, and other arrangements due to status as an independent contractor of the service recipient (independent contractor arrangements). For example, where a service provider deferred amounts under an independent contractor arrangement while providing services as an independent contractor, and then becomes eligible for and defers amounts under a separate employee arrangement after being hired as an employee, the two arrangements will not be aggregated for purposes of this paragraph (c)(2). Where an employee also is a member of the board of directors of the service recipient (or a similar position with respect to a non-corporate service recipient), the arrangements under which the employee participates as a director (director arrangements) are not aggregated with employee arrangements, provided that the director arrangements are substantially similar to arrangements provided to service providers providing services only as directors (or similar positions with respect to non-corporate service recipients). For example, an employee director who participates in an employee arrangement and a director arrangement generally may treat the two arrangements as separate plans, provided that the director arrangement is substantially similar to arrangements providing benefits to non-employee directors. To the extent a plan in which an employee director participates is not substantially similar to arrangements in which non-employee directors participate, such plan is treated as an employee plan for purposes of this paragraph (c)(2). Director plans and independent contractor plans are aggregated for purposes of this paragraph (c)(2).

(3) *Establishment of plan—(i) In general.* A plan does not satisfy the requirements of section 409A and this section and §§1.409A-2 through 1.409A-3 and §§1.409A-5 through 1.409A-6, unless the plan is established and maintained by a service recipient in accordance with the requirements of this section, §§1.409A-2

through 1.409A-3 and §§1.409A-5 through 1.409A-6. For purposes of this paragraph (c)(3), a plan is established on the latest of the date on which it is adopted, the date on which it is effective, and the date on which the material terms of the plan are set forth in writing. The material terms of the plan may be set forth in writing in one or more documents. For purposes of this paragraph (c)(3)(i), a plan will be deemed to be set forth in writing if it is set forth in any other form that is approved by the Commissioner. The material terms of the plan include the amount (or the method or formula for determining the amount) of deferred compensation to be provided under the plan and the time and form of payment. Notwithstanding the foregoing, a plan will be deemed to be established as of the date the participant obtains a legally binding right to a deferral of compensation, provided that the plan is otherwise established under the rules of this paragraph (c)(3)(i) by the end of the taxable year of the service provider in which the legally binding right arises, or with respect to an amount not payable in the year immediately following the taxable year of the service provider in which the legally binding right arises (the subsequent year), the 15th day of the third month of the subsequent year.

(ii) *Initial deferral election provisions.* If a plan provides a service provider or a service recipient with an initial deferral election, the plan satisfies the requirements of this paragraph (c)(3) if the plan sets forth in writing, on or before the date the applicable election is required to be irrevocable to satisfy the requirements of §1.409A-2(a), the conditions under which such election may be made.

(iii) *Subsequent deferral election provisions.* If a plan permits a subsequent deferral election described in §1.409A-2(b), the plan satisfies the requirements of this paragraph (c)(3) if the plan sets forth in writing, on or before the date the election is required to be irrevocable to meet the requirements of §1.409A-2(b), the conditions under which such election may be made.

(iv) *Payment accelerations.* Except as explicitly provided in §1.409A-3, a plan is not required to set forth in writing the conditions under which a payment may be accelerated if such acceleration is permitted under §1.409A-3(j)(4).

(v) *Six-month delay for specified employees.* A plan must provide that distributions to a specified employee may not be made before the date that is six months after the date of separation from service or, if earlier, the date of death (the six-month delay rule). The six-month delay rule, required for payments due to the separation from service of a specified employee, must be written in the plan. A plan does not fail to be established and maintained merely because it does not contain the six-month delay rule when the service provider who has a right to compensation deferred under such plan is not a specified employee. However, such provision must be set forth in writing on or before the date such service provider first becomes a specified employee. In general, this means the provision must be set forth in writing on or before the specified employee effective date (as defined in paragraph (i)(3) of this section) for the first list of specified employees that includes such service provider.

(vi) *Plan amendments.* In the case of an amendment that increases the amount deferred under a nonqualified deferred compensation plan, the plan is not considered established with respect to the additional amount deferred until the plan, as amended, is established in accordance with paragraph (c)(3)(i) of this section.

(vii) *Transition rule for written plan requirement.* For purposes of this paragraph (c)(3), a legally enforceable unwritten plan that was adopted and effective before December 31, 2007, is treated as established under this section as of the later of the date on which it was adopted or became effective, provided that the material terms of the plan are set forth in writing on or before December 31, 2007.

(viii) *Plan aggregation rules.* The plan aggregation rules of paragraph (c)(2)(i) of this section do not apply to the requirements of this paragraph (c)(3). Accordingly, deferrals of compensation under an agreement, method, program, or other arrangement that fails to meet the requirements of section 409A solely due to a failure to meet the requirements of this paragraph (c)(3) are not aggregated with deferrals of compensation under other agreements, methods, programs, or other arrangements that meet such requirements.

(d) *Substantial risk of forfeiture—(1) In general.* Compensation is subject to a substantial risk of forfeiture if entitlement to

the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. For purposes of this paragraph (d), a condition related to a purpose of the compensation must relate to the service provider's performance for the service recipient or the service recipient's business activities or organizational goals (for example, the attainment of a prescribed level of earnings or equity value or completion of an initial public offering). For purposes of this paragraph (d), if a service provider's entitlement to the amount is conditioned on the occurrence of the service provider's involuntary separation from service without cause, the right is subject to a substantial risk of forfeiture if the possibility of forfeiture is substantial. An amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from the performance of services. Except as provided with respect to certain transaction-based compensation under §1.409A-3(i)(5)(iv), the addition of any risk of forfeiture after the legally binding right to the compensation arises, or any extension of a period during which compensation is subject to a risk of forfeiture, is disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture. An amount will not be considered subject to a substantial risk of forfeiture beyond the date or time at which the recipient otherwise could have elected to receive the amount of compensation, unless the present value of the amount subject to a substantial risk of forfeiture (disregarding, in determining the present value, the risk of forfeiture) is materially greater than the present value of the amount the recipient otherwise could have elected to receive absent such risk of forfeiture. For this purpose, compensation that the service provider would receive for continuing to perform services regardless of whether the service provider elected to receive the amount that is subject to a substantial risk of forfeiture is not taken into account in determining whether the present value of the right to the amount subject to a substantial risk of forfeiture is materially greater than the amount the recipient otherwise could have elected to receive absent such risk of forfeiture. For

example, a salary deferral generally may not be made subject to a substantial risk of forfeiture. But, for example, where a bonus plan provides an election between a cash payment or restricted stock units with a present value that is materially greater (disregarding the risk of forfeiture) than the present value of such cash payment and that will be forfeited absent continued services for a period of years, the right to the restricted stock units generally will be treated as subject to a substantial risk of forfeiture.

(2) *Stock rights.* A stock right is not subject to a substantial risk of forfeiture at the earlier of the first date the holder may exercise the stock right and receive cash or property that is substantially vested (as defined in §1.83-3(b)) or the first date that the stock right is not subject to a forfeiture condition that would constitute a substantial risk of forfeiture. Accordingly, a stock option that the service provider may exercise immediately and receive substantially vested stock is not subject to a substantial risk of forfeiture, even if the stock option automatically terminates upon the service provider's separation from service.

(3) *Enforcement of forfeiture condition—(i) In general.* In determining whether the possibility of forfeiture is substantial in the case of rights to compensation granted by a service recipient to a service provider that owns a significant amount of the total combined voting power or value of all classes of equity of the service recipient (where the service provider's ownership is determined with application of the attribution rules under section 318 if the service recipient is a corporation, or if the service recipient is an entity that is not a corporation, with application by analogy of the attribution rules under section 318), all relevant facts and circumstances will be taken into account in determining whether the probability of the service recipient enforcing such condition is substantial, including—

(A) The service provider's relationship to other equity holders and the extent of their control, potential control and possible loss of control of the service recipient;

(B) The position of the service provider in the service recipient and the extent to which the service provider is subordinate to other service providers;

(C) The service provider's relationship to the officers and directors of the service

recipient (or similar positions with respect to a noncorporate service recipient);

(D) The person or persons who must approve the service provider's discharge; and

(E) Past actions of the service recipient in enforcing the restrictions.

(ii) *Examples.* The following examples illustrate the rules of paragraph (d)(3)(i) of this section:

Example 1. A service provider would be considered as having deferred compensation subject to a substantial risk of forfeiture, but for the fact that the service provider owns 20 percent of the single class of stock in the transferor corporation. If the remaining 80 percent of the class of stock is owned by an unrelated individual (or members of such an individual's family) so that the possibility of the corporation enforcing a restriction on such rights is substantial, then such rights are subject to a substantial risk of forfeiture.

Example 2. A service provider would be considered as having deferred compensation subject to a substantial risk of forfeiture, but for the fact that the service provider, who is president of the corporation, also owns 4 percent of the voting power of all the stock of a corporation. If the remaining stock is so diversely held by the public that the president, in effect, controls the corporation, then the possibility of the corporation enforcing a restriction on the right to deferred compensation of the president is not substantial, and such rights are not subject to a substantial risk of forfeiture.

(e) *Performance-based compensation*—(1) *In general.* The term *performance-based compensation* means compensation the amount of which, or the entitlement to which, is contingent on the satisfaction of preestablished organizational or individual performance criteria relating to a performance period of at least 12 consecutive months. Organizational or individual performance criteria are considered preestablished if established in writing by not later than 90 days after the commencement of the period of service to which the criteria relates, provided that the outcome is substantially uncertain at the time the criteria are established. Performance-based compensation may include payments based on performance criteria that are not approved by a compensation committee of the board of directors (or similar entity in the case of a non-corporate service recipient) or by the stockholders or members of the service recipient. Performance-based compensation does not include any amount or portion of any amount that will be paid either regardless of performance, or based upon a level of performance that is substantially certain to be met at the time

the criteria is established. In addition, except as provided in paragraph (e)(3) of this section, compensation is not performance-based compensation merely because the amount of such compensation is determined by reference to the value of the service recipient or the stock of the service recipient. Where a portion of an amount of compensation would qualify as performance-based compensation if the portion were the sole amount available under the plan, that portion of the award will not fail to qualify as performance-based compensation if that portion is designated separately or otherwise separately identifiable under the terms of the plan, and the amount of each portion is determined independently of the other. Compensation may be performance-based compensation where the amount will be paid regardless of satisfaction of the performance criteria due to the service provider's death, disability, or a change in control event (as defined in §1.409A-3(i)(5)(i)), provided that a payment made under such circumstances without regard to the satisfaction of the performance criteria will not constitute performance-based compensation. For purposes of this paragraph (e)(1), a disability refers to any medically determinable physical or mental impairment resulting in the service provider's inability to perform the duties of his or her position or any substantially similar position, where such impairment can be expected to result in death or can be expected to last for a continuous period of not less than six months.

(2) *Payments based upon subjective performance criteria.* The term *performance-based compensation* includes payments based upon subjective performance criteria, provided that—

(i) The subjective performance criteria are *bona fide* and relate to the performance of the participant service provider, a group of service providers that includes the participant service provider, or a business unit for which the participant service provider provides services (which may include the entire organization); and

(ii) The determination that any subjective performance criteria have been met is not made by the participant service provider or a family member of the participant service provider (as defined in section 267(c)(4) applied as if the family of an individual includes the spouse of any

member of the family), or a person under the effective control of the participant service provider or such a family member, and no amount of the compensation of the person making such determination is effectively controlled in whole or in part by the service provider or such a family member.

(3) *Equity-based compensation.* Compensation is performance-based compensation if it is based solely on an increase in the value of the service recipient, or a share of stock in the service recipient, after the date of a grant or award. However, compensation payable for a service period that is equal to the value of a predetermined number of shares of stock, and is variable only to the extent that the value of such shares appreciates or depreciates, generally will not be performance-based compensation. Notwithstanding the foregoing, the attainment of a prescribed value for the service recipient (or a portion thereof), or a share of stock in the service recipient, may be used as a preestablished organizational criterion for purposes of providing performance-based compensation, provided that the other requirements of paragraph (e)(1) of this section are satisfied. In addition, an award of equity-based compensation may constitute performance-based compensation if entitlement to the compensation is subject to a condition that would cause the award to otherwise qualify as performance-based compensation, such as a performance-based vesting condition. A provision that allows a service provider to defer compensation that would be realized upon the exercise of a stock right generally constitutes an additional deferral feature for purposes of the definition of a deferral of compensation under paragraph (b)(5) of this section.

(f) *Service provider*—(1) *In general.* The term *service provider* includes an individual, corporation, subchapter S corporation, partnership, personal service corporation (as defined in section 269A(b)(1)), noncorporate entity that would be a personal service corporation if it were a corporation, qualified personal service corporation (as defined in section 448(d)(2)), and noncorporate entity that would be a qualified personal service corporation if it were a corporation, for any taxable year in which such individual, corporation, subchapter S corporation, partnership, or other entity accounts for gross income

from the performance of services under the cash receipts and disbursements method of accounting. The term *service provider* generally includes a person who has separated from service (a former service provider).

(2) *Independent contractors*—(i) *In general*. Except as otherwise provided in paragraph (f)(2)(iv) of this section, section 409A does not apply to an amount deferred under a plan between a service provider and service recipient with respect to a particular trade or business in which the service provider participates, including earnings credited to such deferred amount, if during the service provider's taxable year in which the service provider obtains a legally binding right to the payment of the amount deferred each of the following applies:

(A) The service provider is actively engaged in the trade or business of providing services, other than as an employee or as a member of the board of directors of a corporation (or similar position with respect to an entity that is not a corporation).

(B) The service provider provides significant services to two or more service recipients to which the service provider is not related and that are not related to one another (as defined in paragraph (f)(2)(ii) of this section).

(C) The service provider is not related to the service recipient, applying the definition of related person contained in paragraph (f)(2)(ii) of this section subject to the modification that the language "20 percent" is not used instead of "50 percent" each place "50 percent" appears in sections 267(b) and 707(b)(1).

(ii) *Related person*. For purposes of this paragraph (f)(2), a person is related to another person if the persons bear a relationship to each other that is specified in section 267(b) or 707(b)(1), subject to the modifications that the language "20 percent" is used instead of "50 percent" each place it appears in sections 267(b) and 707(b)(1), and section 267(c)(4) is applied as if the family of an individual includes the spouse of any member of the family; or the persons are engaged in trades or businesses under common control (within the meaning of section 52(a) and (b)). In addition, an individual is related to an entity if the individual is an officer of an entity that is a corporation, or holds a position sub-

stantially similar to an officer of a corporation with an entity that is not a corporation.

(iii) *Significant services*. Whether a service provider is providing significant services depends on the facts and circumstances of each case. However, for purposes of paragraph (f)(2)(i) of this section, a service provider who provides services to two or more service recipients to which the service provider is not related and that are not related to one another is deemed to be providing significant services to two or more of such service recipients for a given taxable year, if the revenues generated from the services provided to any service recipient or group of related service recipients during such taxable year do not exceed 70 percent of the total revenue generated by the service provider from the trade or business of providing such services. In addition, in the case of a service provider who has been providing services in a trade or business for a period of not less than three consecutive years, for purposes of paragraph (f)(2)(i) of this section, a service provider who provides services to two or more service recipients to which the service provider is not related and that are not related to one another is deemed to be providing significant services to two or more of such service recipients for a given taxable year if in each of the prior three taxable years the revenues generated from the services provided to any service recipient or group of related service recipients during such prior taxable years did not exceed 70 percent of the total revenue generated by the service provider from the trade or business of providing such services and, at the time an amount is deferred, the service provider does not know or have reason to anticipate that the revenues generated from the services provided to any service recipient or group of related service recipients during the current year will exceed 70 percent of the total revenue generated by the service provider from the trade or business of providing such services.

(iv) *Management services*. This paragraph (f)(2) does not apply to a service provider to the extent the service provider provides management services to a service recipient. For purposes of this paragraph (f)(2)(iv), the term *management services* means services that involve the actual or *de facto* direction or control of the financial or operational aspects of a trade or business of the service recipient, or investment

management or advisory services provided to a service recipient whose primary trade or business includes the investment of financial assets (including investments in real estate), such as a hedge fund or a real estate investment trust.

(v) *Services provided to related persons*. Section 409A does not apply to an amount deferred under a plan that is a *bona fide* agreement, method, program, or other arrangement between a service provider and a related service recipient arising in the ordinary course of a particular trade or business in which the service provider is engaged to the extent that—

(A) The service provider provides services to the service recipient as an independent contractor;

(B) During the service provider's taxable year in which the amount is deferred, the service provider qualifies for the safe harbor provided in paragraph (f)(2)(iii) of this section with respect to such trade or business; and

(C) Such agreement, method, program, or other arrangement and the practices thereunder (including billing and collection practices), are substantially similar to the agreements, methods, programs, or other arrangements and practices applicable to one or more unrelated service recipients to whom the service provider provides substantial services and that produce a majority of the total revenue that the service provider earns from the trade or business of providing such services during the taxable year.

(g) *Service recipient*. Except as otherwise specifically provided in these regulations, the term *service recipient* means the person for whom the services are performed and with respect to whom the legally binding right to compensation arises, and all persons with whom such person would be considered a single employer under section 414(b) (employees of controlled group of corporations), and all persons with whom such person would be considered a single employer under section 414(c) (employees of partnerships, proprietorships, etc., under common control). For example, if the service provider is an employee, the service recipient generally is the employer (including all persons treated as a single employer under section 414(b) or (c)). Notwithstanding the foregoing, section 409A applies to a plan that provides for the deferral of compensation,

even if the payment of the compensation is not made by the person for whom services are performed.

(h) *Separation from service*—(1) *Employees*—(i) *In general*. An employee separates from service with the employer if the employee dies, retires, or otherwise has a termination of employment with the employer. However, for purposes of this paragraph (h)(1), the employment relationship is treated as continuing intact while the individual is on military leave, sick leave, or other *bona fide* leave of absence if the period of such leave does not exceed six months, or if longer, so long as the individual retains a right to reemployment with the service recipient under an applicable statute or by contract. For purposes of this paragraph (h)(1), a leave of absence constitutes a *bona fide* leave of absence only if there is a reasonable expectation that the employee will return to perform services for the employer. If the period of leave exceeds six months and the individual does not retain a right to reemployment under an applicable statute or by contract, the employment relationship is deemed to terminate on the first date immediately following such six-month period. Notwithstanding the foregoing, where a leave of absence is due to any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than six months, where such impairment causes the employee to be unable to perform the duties of his or her position of employment or any substantially similar position of employment, a 29-month period of absence may be substituted for such six-month period.

(ii) *Termination of employment*. Whether a termination of employment has occurred is determined based on whether the facts and circumstances indicate that the employer and employee reasonably anticipated that no further services would be performed after a certain date or that the level of *bona fide* services the employee would perform after such date (whether as an employee or as an independent contractor) would permanently decrease to no more than 20 percent of the average level of *bona fide* services performed (whether as an employee or an independent contractor) over the immediately preceding 36-month period (or the full period of services to the employer if the employee has

been providing services to the employer less than 36 months). Facts and circumstances to be considered in making this determination include, but are not limited to, whether the employee continues to be treated as an employee for other purposes (such as continuation of salary and participation in employee benefit programs), whether similarly situated service providers have been treated consistently, and whether the employee is permitted, and realistically available, to perform services for other service recipients in the same line of business. An employee is presumed to have separated from service where the level of *bona fide* services performed decreases to a level equal to 20 percent or less of the average level of services performed by the employee during the immediately preceding 36-month period. An employee will be presumed not to have separated from service where the level of *bona fide* services performed continues at a level that is 50 percent or more of the average level of service performed by the employee during the immediately preceding 36-month period. No presumption applies to a decrease in the level of *bona fide* services performed to a level that is more than 20 percent and less than 50 percent of the average level of *bona fide* services performed during the immediately preceding 36-month period. The presumption is rebuttable by demonstrating that the employer and the employee reasonably anticipated that as of a certain date the level of *bona fide* services would be reduced permanently to a level less than or equal to 20 percent of the average level of *bona fide* services provided during the immediately preceding 36-month period or full period of services provided to the employer if the employee has been providing services to the service recipient for a period of less than 36 months (or that the level of *bona fide* services would not be so reduced). For example, an employee may demonstrate that the employer and employee reasonably anticipated that the employee would cease providing services, but that, after the original cessation of services, business circumstances such as termination of the employee's replacement caused the employee to return to employment. Although the employee's return to employment may cause the employee to be presumed to have continued in employment because the employee is

providing services at a rate equal to the rate at which the employee was providing services before the termination of employment, the facts and circumstances in this case would demonstrate that at the time the employee originally ceased to provide services, the employee and the service recipient reasonably anticipated that the employee would not provide services in the future. Notwithstanding the foregoing provisions of this paragraph (h)(1)(ii), a plan may treat another level of reasonably anticipated permanent reduction in the level of *bona fide* services as a separation from service, provided that the level of reduction required must be designated in writing as a specific percentage, and the reasonably anticipated reduced level of *bona fide* services must be greater than 20 percent but less than 50 percent of the average level of *bona fide* services provided in the immediately preceding 36 months. The plan must specify the definition of separation from service on or before the date on which a separation from service is designated as a time of payment of the applicable amount deferred, and once designated, any change to the definition of separation from service with respect to such amount deferred will be subject to the rules regarding subsequent deferrals and the acceleration of payments. For purposes of this paragraph (h)(1)(ii), for periods during which an employee is on a paid *bona fide* leave of absence (as defined in paragraph (h)(1)(i) of this section) and has not otherwise terminated employment pursuant to paragraph (h)(1)(i) of this section, the employee is treated as providing *bona fide* services at a level equal to the level of services that the employee would have been required to perform to receive the compensation paid with respect to such leave of absence. Periods during which an employee is on an unpaid *bona fide* leave of absence (as defined in paragraph (h)(1)(i) of this section) and has not otherwise terminated employment pursuant to paragraph (h)(1)(i) of this section, are disregarded for purposes of this paragraph (h)(1)(ii) (including for purposes of determining the applicable 36-month (or shorter) period).

(2) *Independent contractors*—(i) *In general*. An independent contractor is considered to have a separation from service with the service recipient upon the expiration of the contract (or in the case

of more than one contract, all contracts) under which services are performed for the service recipient if the expiration constitutes a good-faith and complete termination of the contractual relationship. An expiration does not constitute a good faith and complete termination of the contractual relationship if the service recipient anticipates a renewal of a contractual relationship or the independent contractor becoming an employee. For this purpose, a service recipient is considered to anticipate the renewal of the contractual relationship with an independent contractor if it intends to contract again for the services provided under the expired contract, and neither the service recipient nor the independent contractor has eliminated the independent contractor as a possible provider of services under any such new contract. Further, a service recipient is considered to intend to contract again for the services provided under an expired contract if the service recipient's doing so is conditioned only upon incurring a need for the services, the availability of funds, or both.

(ii) *Special rule.* Notwithstanding paragraph (h)(2)(i) of this section, a plan is considered to satisfy the requirement described in §1.409A-3(a)(1) with respect to an amount payable upon a separation from service if, with respect to amounts payable to a service provider who is an independent contractor, the plan provides that—

(A) No amount will be paid to the service provider before a date at least 12 months after the day on which the contract expires under which the service provider performs services for the service recipient (or, in the case of more than one contract, all such contracts expire); and

(B) No amount payable to the service provider on that date will be paid to the service provider if, after the expiration of the contract (or contracts) and before that date, the service provider performs services for the service recipient as an independent contractor or an employee.

(3) *Definition of service recipient and employer.* For purposes of this paragraph (h), the term *service recipient* or *employer* means the service recipient as defined in paragraph (g) of this section, provided that in applying section 1563(a)(1), (2), and (3) for purposes of determining a controlled group of corporations under section 414(b), the language “at

least 50 percent” is used instead of “at least 80 percent” each place it appears in section 1563(a)(1), (2), and (3), and in applying §1.414(c)-2 for purposes of determining trades or businesses (whether or not incorporated) that are under common control for purposes of section 414(c), “at least 50 percent” is used instead of “at least 80 percent” each place it appears in §1.414(c)-2. A plan may provide with respect to a deferral of compensation under the plan that in applying sections 1563(a)(1), (2), and (3) for purposes of determining a controlled group of corporations under section 414(b), another defined percentage greater than 50 percent, but not greater than 80 percent, is used instead of “at least 80 percent” at each place it appears in sections 1563(a)(1), (2), and (3), and in applying §1.414(c)-2 for purposes of determining trades or businesses (whether or not incorporated) that are under common control for purposes of section 414(c), another defined percentage greater than 50 percent, but not greater than 80 percent, is used instead of “at least 80 percent” at each place it appears in §1.414(c)-2. In addition, where the use of such definition of service recipient for purposes of determining a separation from service is based upon legitimate business criteria, the plan may provide that for purposes of a deferral of compensation under the plan that in applying sections 1563(a)(1), (2), and (3) for purposes of determining a controlled group of corporations under section 414(b), the language “at least 20 percent” or another defined percentage not less than 20 percent but not greater than 50 percent is used instead of “at least 80 percent” at each place it appears in sections 1563(a)(1), (2), and (3), and in applying §1.414(c)-2 for purposes of determining trades or businesses (whether or not incorporated) that are under common control for purposes of section 414(c), the language “at least 20 percent” or another defined percentage not less than 20 percent but not greater than 50 percent is used instead of “at least 80 percent” at each place it appears in §1.414(c)-2. Where a definition of service recipient or employer other than the definition provided in the first sentence of this paragraph (h)(3) (the 50 percent standard) is used, the plan must designate in writing the alternate definition no later than the last date at which the time and

form of payment of the applicable amount deferred must be elected in accordance with §1.409A-2(a), and any change in the definition for such amounts deferred will constitute a change in the time and form of payment subject to the rules governing subsequent deferral elections under §1.409A-2(b) and the acceleration of payments under §1.409A-3(j).

(4) *Asset purchase transactions.* Where as part of a sale or other disposition of assets by one service recipient (seller) to an unrelated service recipient (buyer), a service provider of the seller would otherwise experience a separation from service with the seller, the seller and the buyer may retain the discretion to specify, and may specify, whether a service provider providing services to the seller immediately before the asset purchase transaction and providing services to the buyer after and in connection with the asset purchase transaction has experienced a separation from service for purposes of this paragraph (h), provided that the asset purchase transaction results from *bona fide*, arm's length negotiations, all service providers providing services to the seller immediately before the asset purchase transaction and providing services to the buyer after and in connection with the asset purchase transaction are treated consistently (regardless of position at the seller) for purposes of applying the provisions of any nonqualified deferred compensation plan, and such treatment is specified in writing no later than the closing date of the asset purchase transaction. For purposes of this paragraph (h)(4), references to a sale or other disposition of assets, or an asset purchase transaction, refer only to a transfer of substantial assets, such as a plant or division or substantially all the assets of a trade or business. For purposes of this paragraph (h)(4), whether a service recipient is related to another service recipient is determined under the rules provided in paragraph (f)(2)(ii) of this section.

(5) *Dual status.* If a service provider provides services both as an employee of a service recipient and as an independent contractor of a service recipient, the service provider must separate from service both as an employee and as an independent contractor to be treated as having separated from service. If a service provider ceases providing services as an independent contractor and begins providing ser-

services as an employee, or ceases providing services as an employee and begins providing services as an independent contractor, the service provider will not be considered to have a separation from service until the service provider has ceased providing services in both capacities. Notwithstanding the foregoing, if a service provider provides services both as an employee of a service recipient and a member of the board of directors of a corporate service recipient (or an analogous position with respect to a non-corporate service recipient), the services provided as a director are not taken into account in determining whether the service provider has a separation from service as an employee for purposes of a nonqualified deferred compensation plan in which the service provider participates as an employee that is not aggregated with any plan in which the service provider participates as a director under paragraph (c)(2)(ii) of this section. In addition, if a service provider provides services both as an employee of a service recipient and a member of the board of directors of a corporate service recipient (or an analogous position with respect to a non-corporate service recipient), the services provided as an employee are not taken into account in determining whether the service provider has a separation from service as a director for purposes of a nonqualified deferred compensation plan in which the service provider participates as a director that is not aggregated with any plan in which the service provider participates as an employee under paragraph (c)(2)(ii) of this section.

(6) *Collectively bargained plans covering multiple employers.* Notwithstanding the foregoing provisions of this paragraph (h), to the extent a plan is established pursuant to a *bona fide* collective bargaining agreement covering services performed by employees for multiple employers, such plan may define a separation from service in a reasonable manner that treats the employee as not having separated from service during periods in which the employee is not providing services but is available to perform services covered by the collective bargaining agreement for one or more employers, provided that the definition also provides that the employee must be deemed to have separated from service at a specified date not later than the end of any period of at least 12 consec-

utive months during which the employee has not provided any services covered by the collective bargaining agreement to any participating employer. This paragraph (h)(6) applies only if the definition of separation from service provided by the collective bargaining agreement was the subject of arm's length negotiations between employee representatives and two or more employers, the agreement between employee representatives and such employers satisfies section 7701(a)(46), and the circumstances surrounding the agreement evidence good faith bargaining between adverse parties over such definition.

(i) *Specified employee*—(1) *In general.* The term *specified employee* means a service provider who, as of the date of the service provider's separation from service, is a key employee of a service recipient any stock of which is publicly traded on an established securities market or otherwise. For purposes of this paragraph (i)(1), a service provider is a key employee if the service provider meets the requirements of section 416(i)(1)(A)(i), (ii), or (iii) (applied in accordance with the regulations thereunder and disregarding section 416(i)(5)) at any time during the 12-month period ending on a specified employee identification date. If a service provider is a key employee as of a specified employee identification date, the service provider is treated as a key employee for purposes of this paragraph (i) for the entire 12-month period beginning on the specified employee effective date.

(2) *Definition of compensation.* For purposes of identifying a specified employee by applying the requirements of section 416(i)(1)(A)(i), (ii), and (iii), the definition of compensation under §1.415(c)-2(a) is used, applied as if the service recipient were not using any safe harbor provided in §1.415(c)-2(d), were not using any of the elective special timing rules provided in §1.415(c)-2(e), and were not using any of the elective special rules provided in §1.415(c)-2(g). Notwithstanding the foregoing, a service recipient may elect to use any available definition of compensation under section 415 and the regulations thereunder in accordance with the election requirements set forth in paragraph (i)(8) of this section, including any available safe harbor and any available election under the timing rules or

special rules, provided that the definition is applied consistently to all employees of the service recipient for purposes of identifying specified employees. A service recipient may elect to use such an alternative definition regardless of whether another definition of compensation is being used for purposes of a qualified plan sponsored by the service recipient. However, once a list of specified employees has become effective, the service recipient cannot change the definition of compensation for purposes of identifying specified employees for the period with respect to which such list is effective.

(3) *Specified employee identification date.* Unless another date is designated in accordance with the requirements of this paragraph (i)(3) and paragraph (i)(8) of this section, the specified employee identification date is December 31. A service recipient may designate in accordance with the requirements of paragraph (i)(8) of this section any other date as the specified employee identification date, provided that a service recipient must use the same specified employee identification date with respect to all nonqualified deferred compensation plans, and any change to the specified employee identification date may not be effective for a period of at least 12 months. The service recipient may designate a specified employee identification date in each plan or in a separate document applicable to all plans, provided that the service recipient will not be treated as having designated a specified employee identification date before the designation is legally binding on the service recipient and all affected service providers. Any designation of a specified employee identification date made on or before December 31, 2007, may be applied to any separation from service occurring on or after January 1, 2005, unless and until subsequently changed pursuant to this paragraph (i)(3).

(4) *Specified employee effective date.* Unless another date is designated in accordance with the requirements of this paragraph (i)(4) and paragraph (i)(8) of this section, the specified employee effective date is the first day of the fourth month following the specified employee identification date. A service recipient may designate in accordance with the requirements of paragraph (i)(8) of this section any date following the specified employee

identification date as the specified employee effective date, provided that such date may not be later than the first day of the fourth month following the specified employee identification date, and provided further that a service recipient must use the same specified employee effective date with respect to all nonqualified deferred compensation plans, and any change to the specified employee effective date may not be effective for a period of at least 12 months. The service recipient may designate a specified employee effective date through inclusion in each plan document or through a separate document applicable to all plans, provided that the service recipient will not be treated as having designated a specified employee effective date on any date before the designation is legally binding on the service recipient and all affected service providers. Any designation of a specified employee effective date made on or before December 31, 2007, may be applied to any separation from service occurring on or after January 1, 2005, unless and until subsequently changed pursuant to this paragraph (i)(4).

(5) *Alternative methods of satisfying the six-month delay rule.* A plan may provide, in accordance with the requirements of paragraph (i)(8) of this section, for an alternative method to identify service providers who will be subject to the six-month delay rule provided in section 409A(a)(2)(B)(i), provided that the alternative method is reasonably designed to include all specified employees (determined without respect to any available service recipient elections), the alternative method is an objectively determinable standard providing no direct or indirect election to any service provider regarding its application, and the alternative method results in either all service providers or no more than 200 service providers being identified in the class as of any date. Use of such an alternative method will not be treated as a change in the time and form of payment for purposes of §1.409A-2(b) (the subsequent deferral rules), even if the service provider is not a specified employee when the payment is delayed.

(6) *Corporate transactions—(i) Mergers and acquisitions of public service recipients.* If as a result of a corporate transaction, two or more separate service recipients, more than one of which has stock outstanding that is publicly traded on an estab-

lished securities market or otherwise immediately before the transaction, become one service recipient, any stock of which is publicly traded on an established securities market or otherwise immediately after the transaction (resulting public service recipient), the resulting public service recipient's next specified employee identification date and specified employee effective date following the corporate transaction are the specified employee identification date and specified employee effective date that the acquiring service recipient would have been required to use absent such transaction. For this purpose, in the case of a corporate merger, the acquiring service recipient is the service recipient that included the surviving corporation in such merger, in the case of an acquisition by a corporation of the stock of another corporation, the acquiring service recipient is the service recipient that included the corporation that acquired such stock, and in all other cases, the surviving service recipient is determined on the basis of all of the facts and circumstances. For the period between the transaction and the next specified employee effective date, the list of specified employees of the resulting public service recipient is determined by combining the lists of specified employees of all service recipients participating in the transaction that were in effect at the date of the corporate transaction, ranking such specified employees in order of the amount of compensation used to determine each specified employee's status as a specified employee, and treating the top 50 of such specified employees, plus any employees described in section 416(i)(1)(ii) or section 416(i)(1)(iii) and the regulations thereunder (relating to 1-percent and 5-percent owners) who are not included in such top 50 specified employees, as specified employees for the period between the corporate transaction and the next specified employee effective date. Alternatively, the resulting service recipient may elect in accordance with the requirements of paragraph (i)(8) of this section to use any reasonable method to determine the specified employees of the resulting service recipient, including the use of an alternative method of compliance described in paragraph (i)(5) of this section, provided that such method is adopted no later than 90 days after the corporate transaction and

applied prospectively from the date the method is adopted.

(ii) *Mergers and acquisitions of non-public service recipients.* If as part of a corporate transaction a service recipient that does not have outstanding stock that is publicly traded on an established securities market or otherwise immediately before the transaction (initial private service recipient), and a service recipient with stock outstanding that is publicly traded on an established securities market or otherwise immediately before the transaction (initial public service recipient), become a single service recipient having stock that is publicly traded on an established securities market or otherwise immediately after the transaction (resulting public service recipient), the resulting public service recipient's next specified employee identification date and specified employee effective date following the corporate transaction are the specified employee identification date and specified employee effective date that the initial public service recipient would have been required to use absent such transaction. For the period after the date of the corporate transaction and before the next specified employee effective date, the specified employees of the initial public service recipient immediately before the transaction continue to be the specified employees of the resulting public service recipient, and no service providers of the initial private service recipient are required to be treated as specified employees.

(iii) *Spinoffs.* If as part of a corporate transaction, a service recipient with stock outstanding that is publicly traded on an established securities market or otherwise immediately before the transaction (initial public service recipient), becomes two or more separate service recipients, each with stock outstanding that is publicly traded on an established securities market or otherwise immediately after the transaction (post-transaction public service recipients), the next specified employee identification date of each of the post-transaction public service recipients is the specified employee identification date that the initial public service recipient would have been required to use absent such transaction. For the period after the date of the corporate transaction and before the next specified employee effective date, the specified employees of the initial public service re-

recipient immediately before the transaction continue to be the specified employees of the post-transaction public service recipients.

(iv) *Public offerings and other corporate transactions.* If as part of an initial public offering or corporate transaction not described in paragraph (i)(6)(ii) or (iii) of this section, a service recipient with no outstanding stock that is publicly traded on an established securities market or otherwise immediately before such offering or other transaction (initial private service recipient), becomes one or more service recipients with stock outstanding that is publicly traded on an established securities market or otherwise immediately after such offering or other transaction (post-transaction public service recipient), each post-transaction public service recipient has a specified employee identification date of December 31 and a specified employee effective date of April 1, effective retroactively to the December 31 and April 1 next preceding the offering or other transaction for purposes of identifying the specified employees between the corporation transaction and the next December 31. Alternatively, a post-transaction public service recipient may elect in accordance with the requirements of paragraph (i)(8) of this section, a specified employee identification date and specified employee effective date on or before the date of the offering or other transaction. If a public service recipient makes such an election, for the period after the offering or other transaction and before the next specified employee effective date, the specified employees of the post-transaction public service recipient consist of the service providers that at the time of the offering or other transaction would have been classified as specified employees of the initial private service recipient, had the initial private service recipient elected the same specified employee identification date and specified employee effective date as selected by the post-transaction public service recipient, and had such initial private service recipient had stock publicly traded on an established securities market or otherwise as of the specified employee identification date preceding the transaction.

(v) *Alternative methods of compliance.* For purposes of this paragraph (i)(6), references to specified employees as of a corporate transaction or offering include any

specified employees identified through the use of an alternative method described in paragraph (i)(5) of this section, where the use of such alternative method was established and effective at the time of the corporate transaction or offering.

(7) *Nonresident alien employees.* For purposes of determining whether an employee meets the requirements of section 416(i)(1)(A)(i), (ii), or (iii) (applied in accordance with the regulations thereunder and disregarding section 416(i)(5)), and therefore is a key employee, the incorporation of the rules of §1.415(c)-2(g)(5) regarding the definition of compensation applies. Accordingly, the rule of §1.415(c)-2(g)(5)(i), generally requiring the treatment as compensation of certain compensation excludible from an employee's gross income due to the location of the services or the identity of the employer, applies. In addition, a service recipient may elect in accordance with paragraph (i)(8) of this section to apply the rule of §1.415(c)-2(g)(5)(ii) to not treat as compensation certain compensation excludible from an employee's gross income on account of the location of the services or the identity of the employer that is not effectively connected with the conduct of a trade or business within the United States. A service recipient may elect to apply the rule of §1.415-2(g)(5)(ii) regardless of whether the service recipient has elected to apply the rule to a qualified plan sponsored by the service recipient; however, once a list of specified employees has become effective, any election of the rule for that period may not be changed. Notwithstanding the foregoing, any election of the rule made before January 1, 2008, may be effective with respect to any specified employee identification date on or before December 31, 2007.

(8) *Elections affecting the identification of specified employees.* The elections described in paragraphs (i)(2) through (7) of this section are effective only as of the date that all necessary corporate action has been taken to make such elections binding for purposes of all affected nonqualified deferred compensation plans in which the service providers of the service recipient that would become a specified employee due to the application of such election participate. Where a taxpayer attempts to make an election under paragraph (i)(2), (3), (4), (5), (6), or (7) of this

section but such election is not binding on all the affected nonqualified deferred compensation plans and applied consistently to all such service providers, the election is not effective and the rule under paragraph (i)(2), (3), (4), (5), (6), or (7) of this section, as applicable, that would apply absent an election is applicable for identifying specified employees.

(j) *Nonresident alien.* (1) Except as provided in paragraph (j)(2) of this section, the term *nonresident alien* means an individual who is—

(i) A nonresident alien within the meaning of section 7701(b)(1)(B); or

(ii) A dual resident taxpayer within the meaning of §301.7701(b)-7(a)(1) of this chapter with respect to any taxable year in which such individual is treated as a nonresident alien for purposes of computing the individual's U.S. income tax liability.

(2) The term *nonresident alien* does not include—

(i) A nonresident alien with respect to whom an election is in effect for the taxable year under section 6013(g) to be treated as a resident of the United States;

(ii) A former citizen or long-term resident (within the meaning of section 877(e)(2)) who expatriated after June 3, 2004, and has not complied with the requirements of section 7701(n); or

(iii) An individual who is treated as a citizen or resident of the United States for the taxable year under section 877(g).

(k) *Established securities market.* The term *established securities market* means an established securities market within the meaning of §1.897-1(m).

(l) *Stock right.* The term *stock right* means a stock option (other than an incentive stock option described in section 422 or an option granted pursuant to an employee stock purchase plan described in section 423) or a stock appreciation right.

(m) *Separation pay plan.* The term *separation pay plan* means any plan that provides separation pay or, where a plan provides both amounts that are separation pay and that are not separation pay, that portion of the plan that provides separation pay. The term *separation pay* means any deferral of compensation (before the application of the exclusions from the definition of a deferral of compensation set forth in paragraph (b)(9) of this section) that will not be paid under any circumstances unless the service provider has had a separa-

tion from service, whether voluntary or involuntary, including payments in the form of reimbursements of expenses incurred, and the provision of in-kind benefits. A deferral of compensation that the service provider may receive without a separation from service does not become separation pay merely because the service provider elects to receive or receives the payment after or upon a separation from service. A deferral of compensation does not fail to be separation pay merely because the payment is conditioned upon the execution of a release of claims, noncompetition or nondisclosure provisions, or other similar requirements. Notwithstanding the foregoing, any amount, or entitlement to any amount, that acts as a substitute for, or replacement of, amounts deferred by the service recipient under a nonqualified deferred compensation plan constitutes a payment of compensation or deferral of compensation under such nonqualified deferred compensation plan.

(n) *Involuntary separation from service*—(1) *In general.* An involuntary separation from service means a separation from service due to the independent exercise of the unilateral authority of the service recipient to terminate the service provider's services, other than due to the service provider's implicit or explicit request, where the service provider was willing and able to continue performing services. An involuntary separation from service may include the service recipient's failure to renew a contract at the time such contract expires, provided that the service provider was willing and able to execute a new contract providing terms and conditions substantially similar to those in the expiring contract and to continue providing such services. The determination of whether a separation from service is involuntary is based on all the facts and circumstances. Any characterization of the separation from service as voluntary or involuntary by the service provider and the service recipient in the documentation of the separation from service is presumed to properly characterize the nature of the separation from service. However, the presumption may be rebutted where the facts and circumstances indicate otherwise. For example, if a separation from service is designated as a voluntary separation from service or resignation, but the facts and circumstances indicate that absent such

voluntary separation from service the service recipient would have terminated the service provider's services, and that the service provider had knowledge that the service provider would be so terminated, the separation from service is involuntary.

(2) *Separations from service for good reason*—(i) *In general.* Notwithstanding paragraph (n)(1) of this section, a service provider's voluntary separation from service will be treated for purposes of this section and §§1.409A-2 through 1.409A-6 as an involuntary separation from service if the separation from service occurs under certain limited *bona fide* conditions, where the avoidance of the requirements of section 409A is not a purpose of the inclusion of these conditions in the plan or of the actions by the service recipient in connection with the satisfaction of these conditions, and a voluntary separation from service under such conditions effectively constitutes an involuntary separation from service. Generally such conditions will be prespecified under an agreement to provide compensation upon a separation from service for good reason. Such a good reason (or a similar condition) must be defined to require actions taken by the service recipient resulting in a material negative change to the service provider in the service relationship, such as the duties to be performed, the conditions under which such duties are to be performed, or the compensation to be received for performing such services. Other factors taken into account in determining whether a separation from service for good reason effectively constitutes an involuntary separation from service include the extent to which the payments upon a separation from service for good reason are in the same amount and are to be made at the same time and in the same form as payments available upon an actual involuntary separation from service, and whether the service provider is required to give the service recipient notice of the existence of the condition that would result in treatment as a separation from service for good reason and a reasonable opportunity to remedy the condition.

(ii) *Safe harbor.* For purposes of this section and §§1.409A-2 through 1.409A-6, if a plan provides that a voluntary separation from service will be treated as an involuntary separation from service if the separation from service occurs under

certain express conditions, a separation from service satisfying the conditions set forth in the plan will be treated as an involuntary separation from the service if the necessary conditions (or set of conditions) require the following:

(A) The separation from service must occur during a pre-determined limited period of time not to exceed two years following the initial existence of one or more of the following conditions arising without the consent of the service provider:

(1) A material diminution in the service provider's base compensation.

(2) A material diminution in the service provider's authority, duties, or responsibilities.

(3) A material diminution in the authority, duties, or responsibilities of the supervisor to whom the service provider is required to report, including a requirement that a service provider report to a corporate officer or employee instead of reporting directly to the board of directors of a corporation (or similar governing body with respect to an entity other than a corporation).

(4) A material diminution in the budget over which the service provider retains authority.

(5) A material change in the geographic location at which the service provider must perform the services.

(6) Any other action or inaction that constitutes a material breach by the service recipient of the agreement under which the service provider provides services.

(B) The amount, time, and form of payment upon the separation from service must be substantially identical to the amount, time and form of payment payable due to an actual involuntary separation from service, to the extent such a right exists.

(C) The service provider must be required to provide notice to the service recipient of the existence of the condition described in paragraph (n)(2)(ii)(A) of this section within a period not to exceed 90 days of the initial existence of the condition, upon the notice of which the service recipient must be provided a period of at least 30 days during which it may remedy the condition and not be required to pay the amount.

(3) *Special rule for certain collectively bargained plans.* Notwithstanding the foregoing, for purposes of this paragraph (n), to the extent a plan is subject to a

bona fide collective bargaining agreement covering services performed for multiple employers under which an employee must separate from service with all such employers in order to receive a payment, such plan may use any reasonable definition of involuntary separation from service, provided that such definition is consistent with any definition of a separation from service adopted under paragraph (h)(6) of this section, and provided further that the definition of an involuntary separation from service provided by the collective bargaining agreement was the subject of arm's length negotiations between employee representatives and two or more employers, the agreement between employee representatives and such employers satisfies section 7701(a)(46), and the circumstances surrounding the agreement evidence good faith bargaining between adverse parties over such definition.

(o) *Earnings.* Whether a deferred amount constitutes earnings on an amount deferred, or actual or notional income attributable to an amount deferred, is determined under the principles defining income attributable to the amount taken into account under §31.3121(v)(2)-1(d)(2) of this chapter. Accordingly, with respect to an account balance plan, earnings on an amount deferred generally include an amount credited on behalf of a service provider under the terms of the plan that reflects a rate of return that does not exceed either the rate of return on a predetermined actual investment or, if the income does not reflect the rate of return on a predetermined actual investment, a reasonable rate of interest. With respect to nonaccount balance plans, earnings on an amount deferred generally include an increase, due solely to the passage of time, in the present value of the future payments to which the service provider has obtained a legally binding right, the present value of which constituted the amount deferred (determined as of the date such amount was deferred), but only if the amount deferred was determined using reasonable actuarial assumptions and methods. A right to earnings on an amount deferred generally is treated as a right to a deferral of compensation for purposes of this section and §§1.409A-2 through 1.409A-6. However, for purposes of any provision of this section and §§1.409A-2 through 1.409A-6 referring to earnings on

deferred compensation (or similar terms), the use of an unreasonable rate of return, or unreasonable actuarial assumptions and methods, generally will result in the treatment of some or all of such a right to deferred compensation as a right only to deferred compensation, and not a right to earnings on deferred compensation, so that the provision will not be applicable. With respect to plans that are neither account balance plans nor nonaccount balance plans, these rules apply by analogy.

(p) *In-kind benefits.* The term *in-kind benefits* refers to services provided to or on behalf of a service provider, such as financial planning services, or tangible personal or real property made available for use by or on behalf of the service provider, such as the use of an aircraft or vehicle, and does not refer to a transfer of property within the meaning of section 83 and the regulations thereunder, or a promise to transfer, or an option to purchase or receive, property in the future.

(q) *Application of definitions and rules.* The definitions and rules set forth in paragraphs (a) through (p) of this section apply for purposes of section 409A, this section, and §§1.409A-2 through 1.409A-6.

§1.409A-2 Deferral elections.

(a) *Initial elections as to the time and form of payment—(1) In general.* A plan that is, or constitutes part of, a nonqualified deferred compensation plan meets the requirements of section 409A(a)(4)(B) only if under the terms of the plan, compensation for services performed during a service provider's taxable year (the service year) may be deferred at the service provider's election only if the election to defer such compensation is made and becomes irrevocable not later than the latest date permitted in this paragraph (a). An election will not be considered to be revocable merely because the service provider or service recipient may make an election to change the time and form of payment pursuant to paragraph (b) of this section, or the service recipient may accelerate the time of payment pursuant to §1.409A-3(j)(4) (exceptions to prohibition on accelerated payments). Whether a plan provides a service provider an opportunity to elect the time or form of payment of compensation is determined based upon all the facts and circumstances

surrounding the determination of the time and form of payment of the compensation. For purposes of this section, an election to defer includes an election as to the time of the payment, an election as to the form of the payment or an election as to both the time and the form of the payment, but does not include an election as to the medium of payment (for example, an election between a payment of cash or a payment of property). Except as otherwise expressly provided in this section, an election will not be considered made until such election becomes irrevocable under the terms of the applicable plan. Accordingly, a plan may provide that an election to defer may be changed at any time before the last permissible date for making such an election. Where a plan provides the service provider a right to make an initial deferral election, and further provides that the election remains in effect until terminated or modified by the service provider, the election will be treated as made as of the date such election becomes irrevocable as to compensation for services performed during the relevant service year. For example, where a plan provides that a service provider's election to defer a set percentage will remain in effect until changed or revoked, but that as of each December 31 the election becomes irrevocable with respect to salary payable in connection with services performed in the immediately following year, the initial deferral election with respect to salary payable with respect to services performed in the immediately following year will be deemed to have been made as of the December 31 upon which the election became irrevocable. For purposes of this paragraph (a), the reference to a service period or a performance period refers to the period of service for which the right to the compensation arises, and may include periods before the grant of a legally binding right to the compensation. For example, where a service recipient grants a bonus based upon services performed in the calendar year 2010, but retains the discretion to rescind the bonus until 2011 such that the promise of the bonus is not a legally binding right, the period of service or performance period to which the compensation relates is the calendar year 2010.

(2) *Service recipient elections.* A plan that provides for a deferral of compensa-

tion for services performed during a service provider's taxable year that does not provide the service provider with an opportunity to elect the time or form of payment of such compensation must designate the time and form of payment by no later than the later of the time the service provider first has a legally binding right to the compensation or, if later, the time the service provider would be required under this section to make such an election if the service provider were provided such an election. Such designation is treated as an initial deferral election for purposes of this section. Where a plan permits a service recipient to exercise discretion to disregard a service provider election as to the time or form of a payment, any service provider election that is subject to such discretion will be treated as revocable so long as such discretion may be exercised.

(3) *General rule.* A plan that is, or constitutes part of, a nonqualified deferred compensation plan meets the requirements of section 409A(a)(4)(B) if under the terms of the plan, compensation for services performed during a service provider's taxable year (the service year) may be deferred at the service provider's election only if the election to defer such compensation is made not later than the close of the service provider's taxable year next preceding the service year.

(4) *Initial deferral election with respect to short-term deferrals.* If a service provider has a legally binding right to a payment of compensation in a subsequent taxable year that, absent a deferral election, would be treated as a short-term deferral within the meaning of §1.409A-1(b)(4), an election to defer such compensation may be made in accordance with the requirements of paragraph (b) of this section, applied as if the amount were a deferral of compensation and the scheduled payment date for the amount were the date the substantial risk of forfeiture lapses. Notwithstanding the requirements of paragraph (b) of this section, such a deferral election may provide that the deferred amounts will be payable upon a change in control event (as defined in §1.409A-3(i)(5)) without regard to the five-year additional deferral requirement in paragraph (b) of this section.

(5) *Initial deferral election with respect to certain forfeitable rights.* If a service provider has a legally binding

right to a payment in a subsequent year that is subject to a condition requiring the service provider to continue to provide services for a period of at least 12 months from the date the service provider obtains the legally binding right to avoid forfeiture of the payment, an election to defer such compensation may be made on or before the 30th day after the service provider obtains the legally binding right to the compensation, provided that the election is made at least 12 months in advance of the earliest date at which the forfeiture condition could lapse. For purposes of this paragraph (a)(5), a condition will not be treated as failing to require the service provider to continue to provide services for a period of at least 12 months from the date the service provider obtains the legally binding right merely because the condition immediately lapses upon the death or disability (as defined in §1.409A-3(i)(4)) of the service provider, or upon a change in control event (as defined in §1.409A-3(i)(5)), provided that if death, disability, or a change in control event occurs and the condition lapses before the end of such 12-month period, a deferral election may be given effect only if the deferral election is permitted under this section without regard to this paragraph (a)(5).

(6) *Initial deferral election with respect to fiscal year compensation.* In the case of a service recipient with a taxable year that is not the same as the taxable year of the service provider, a plan may provide that fiscal year compensation may be deferred at the service provider's election if the election to defer such compensation is made not later than the close of the service recipient's taxable year immediately preceding the first taxable year of the service recipient in which any services are performed for which such compensation is payable. For purposes of this paragraph (a)(6), the term *fiscal year compensation* means compensation relating to a period of service coextensive with one or more consecutive taxable years of the service recipient, of which no amount is paid or payable during the service recipient's taxable year or years constituting the period of service. For example, fiscal year compensation generally would include a bonus to an individual employee with a calendar year taxable year that is based on a service period consisting of the service recip-

ient's two consecutive taxable years ending September 30, 2011, where the amount will be paid after the end of the second of such taxable years, but would not include either a bonus based on a service period consisting of one or more calendar years or salary that would otherwise be paid during such taxable years of the service recipient.

(7) *First year of eligibility—(i) In general.* In the case of the first year in which a service provider becomes eligible to participate in a plan, the service provider may make an initial deferral election within 30 days after the date the service provider becomes eligible to participate in such plan, with respect to compensation paid for services to be performed after the election. In the case of a plan that does not provide for service provider elections with respect to the time or form of a payment, the time and form of the payment must be specified on or before the date that is 30 days after the date the service provider first becomes eligible to participate in such plan. For compensation that is earned based upon a specified performance period (for example, an annual bonus), where a deferral election is made in the first year of eligibility but after the beginning of the performance period, the election must apply only to the compensation paid for services performed after the election. For this purpose, an election will be deemed to apply to compensation paid for services performed after the election if the election applies to no more than an amount equal to the total amount of the compensation for the performance period multiplied by the ratio of the number of days remaining in the performance period after the election over the total number of days in the performance period.

(ii) *Eligibility to participate.* For purposes of this paragraph (a)(7), a service provider is eligible to participate in a plan at any time during which, under the plan's terms and without further amendment or action by the service recipient, the service provider is eligible to accrue an amount of deferred compensation under the plan other than earnings on amounts previously deferred, even if the service provider has elected not to accrue (or has not elected to accrue) an amount of deferred compensation. Where a service provider has been paid all amounts deferred under a plan, and on and before the date of the last payment was not eligible to continue (or to elect to continue) to participate in the plan

for periods after the last payment (other than through an election of a different time and form of payment with respect to the amounts paid), the service provider may be treated as initially eligible to participate in a plan as of the first date following such payment that the service provider becomes eligible to accrue an additional amount of deferred compensation. Where a service provider has ceased being eligible to participate in a plan (other than the accrual of earnings), regardless of whether all amounts deferred under the plan have been paid, and subsequently becomes eligible to participate in the plan again, the service provider may be treated as being initially eligible to participate in the plan if the service provider had not been eligible to participate in the plan (other than the accrual of earnings) at any time during the 24-month period ending on the date the service provider again becomes eligible to participate in the plan.

(iii) *Application to excess benefit plans.* For purposes of this paragraph (a)(7), a service provider is treated as initially eligible to participate in an excess benefit plan as of the first day of the service provider's taxable year immediately following the first year the service provider accrues a benefit under the excess benefit plan; and any election made within 30 days following such date is treated as applying to benefits accrued under such plan for services performed before the election. For purposes of this paragraph (a)(7), the term *excess benefit plan* means all nonqualified deferred compensation plans in which a service provider participates, to the extent such plans do not provide for an election between current compensation (including a short-term deferral) and deferred compensation and solely provide deferred compensation equal to the excess of the benefits the service provider would have accrued under a qualified employer plan (as defined in §1.409A-1(a)(2)) in which the service provider also participates, in the absence of one or more of the limits incorporated into the plan to reflect one or more of the limits on contributions or benefits applicable to the qualified employer plan under the Internal Revenue Code, over the benefits the service provider actually accrues under the qualified employer plan. For purposes of this paragraph (a)(7), once a service provider has accrued a benefit or deferred compensation under a

plan in any year, the service provider will not become eligible for an initial deferral election based upon an accrual or deferral under an excess benefit plan in a subsequent year, even if the benefit or deferred compensation accrued in a previous year is forfeited or eliminated.

(8) *Initial deferral election with respect to performance-based compensation.* In the case of any performance-based compensation (as defined in §1.409A-1(e)), an initial deferral election may be made with respect to such performance-based compensation on or before the date that is six months before the end of the performance period, provided that the service provider performs services continuously from the later of the beginning of the performance period or the date the performance criteria are established through the date an election is made under this paragraph (a)(8), and provided further that in no event may an election to defer performance-based compensation be made after such compensation has become readily ascertainable. For purposes of this paragraph (a)(8), if the performance-based compensation is a specified or calculable amount, the compensation is readily ascertainable if and when the amount is first substantially certain to be paid. If the performance-based compensation is not a specified or calculable amount because, for example, the amount may vary based upon the level of performance, the compensation, or any portion of the compensation, is readily ascertainable when the amount is first both calculable and substantially certain to be paid. For this purpose, the performance-based compensation is bifurcated between the portion that is readily ascertainable and the amount that is not readily ascertainable. Accordingly, in general any minimum amount that is both calculable and substantially certain to be paid will be treated as readily ascertainable.

(9) *Nonqualified deferred compensation plans linked to qualified employer plans or certain other arrangements.* If a nonqualified deferred compensation plan provides that the amount deferred under the plan is determined under the formula for determining benefits under a qualified employer plan (as defined in §1.409A-1(a)(2)) or a broad-based foreign retirement plan (as defined in §1.409A-1(a)(3)(v)) maintained by the service recipient but applied without

regard to one or more limitations applicable to the qualified employer plan under the Internal Revenue Code or to the broad-based foreign retirement plan under other applicable law, or that the amount deferred under the nonqualified deferred compensation plan is determined as an amount offset by some or all of the benefits provided under the qualified employer plan or the broad-based foreign retirement plan, an increase in amounts deferred under the nonqualified deferred compensation plan that results directly from changes in benefit limitations applicable to the qualified employer plan or the broad-based foreign retirement plan under the Internal Revenue Code or other applicable law does not constitute a deferral election under the nonqualified deferred compensation plan, provided that such operation does not otherwise result in a change in the time or form of a payment under the nonqualified deferred compensation plan, and provided further that such change in the amounts deferred under the nonqualified deferred compensation plan does not exceed that change in the amounts deferred under the qualified employer plan or the broad-based foreign retirement plan, as applicable. In addition, with respect to such a nonqualified deferred compensation plan, the following actions or failures to act will not constitute a deferral election under the nonqualified deferred compensation plan even if in accordance with the terms of the nonqualified deferred compensation plan, the actions or inactions result in an increase in the amounts deferred under the plan, provided that such actions or inactions do not otherwise affect the time or form of payment under the nonqualified deferred compensation plan and provided further that with respect to actions or inactions described in paragraphs (a)(9)(i) or (ii), the change in the amount deferred under the nonqualified deferred compensation plan does not exceed the change in the amounts deferred under the qualified employer plan or the broad-based foreign retirement plan, as applicable:

(i) A service provider's action or inaction under the qualified employer plan or broad-based foreign retirement plan with respect to whether to elect to receive a subsidized benefit or an ancillary benefit under the qualified employer plan or broad-based foreign retirement plan.

(ii) The amendment of a qualified employer plan or broad-based foreign retirement plan to add or remove a subsidized benefit or an ancillary benefit, or to freeze or limit future accruals of benefits under the qualified plan or freeze or limit future accruals of benefits or reduce existing benefits under the broad-based foreign retirement plan.

(iii) A service provider's action or inaction under a qualified employer plan with respect to elective deferrals and other employee pre-tax contributions subject to the contribution restrictions under section 401(a)(30) or section 402(g), including an adjustment to a deferral election under such qualified employer plan, provided that for any given taxable year, the service provider's action or inaction does not result in an increase in the amounts deferred under all nonqualified deferred compensation plans in which the service provider participates (other than amounts described in paragraph (a)(9)(iv) of this section) in excess of the limit with respect to elective deferrals under section 402(g)(1)(A), (B), and (C) in effect for the taxable year in which such action or inaction occurs.

(iv) A service provider's action or inaction under a qualified employer plan with respect to elective deferrals and other employee pre-tax contributions subject to the contribution restrictions under section 401(a)(30) or section 402(g), and after-tax contributions by the service provider to a qualified employer plan that provides for such contributions, that affects the amounts that are credited under one or more nonqualified deferred compensation plans as matching amounts or other similar amounts contingent on such elective deferrals, employee pre-tax contributions, or after-tax contributions, provided that the total of such matching or contingent amounts, as applicable, never exceeds 100 percent of the matching or contingent amounts that would be provided under the qualified employer plan absent any plan-based restrictions that reflect limits on qualified plan contributions under the Internal Revenue Code.

(10) *Changes in elections under a cafeteria plan.* A change in an election under a cafeteria plan does not constitute a deferral election with respect to an amount deferred under a nonqualified deferred compensation plan to the extent that the change in the amount deferred under the nonqual-

ified deferred compensation plan results solely from the application of the change in amount eligible to be treated as compensation under the terms of the nonqualified deferred compensation plan resulting from the election change under the cafeteria plan, to a benefit formula under the nonqualified deferred compensation plan based upon the service provider's eligible compensation, and only to the extent that such change applies in the same manner as any other increase or decrease in compensation would apply to such benefit formula.

(11) *Initial deferral election with respect to certain separation pay.* In the case of separation pay (as defined in §1.409A-1(m)), where such separation pay is the subject of *bona fide*, arm's length negotiations at the time of the separation from service, an initial deferral election may be made at any time up to the time the service provider obtains a legally binding right to the payment. This paragraph (a)(11) does not apply to any separation pay to which the service provider obtained a legally binding right before the negotiations at the time of the separation from service, including a right to a payment subject to a condition such as that the service provider separate from service other than for cause. In the case of separation pay due to participation in a window program (as defined in §1.409A-1(b)(9)(vi)), an initial deferral election may be made at any time before the time the election to participate in the window program becomes irrevocable.

(12) *Initial deferral election with respect to certain commissions—(i) Sales commission compensation.* For purposes of this paragraph (a), a service provider earning sales commission compensation is treated as providing the services to which such compensation relates only in the service provider's taxable year in which the customer remits payment to the service recipient or, if applied consistently to all similarly situated service providers, the service provider's taxable year in which the sale occurs. For purposes of this paragraph (a)(12), the term *sales commission compensation* means compensation or portions of compensation earned by a service provider if a substantial portion of the services provided by such service provider to a service recipient consist of the direct sale of a product or service to

an unrelated customer, the compensation paid by the service recipient to the service provider consists of either a portion of the purchase price for the product or service or an amount substantially all of which is calculated by reference to the volume of sales, and payment of the compensation is either contingent upon the service recipient receiving payment from an unrelated customer for the product or services or, if applied consistently to all similarly situated service providers, is contingent upon the closing of the sales transaction and such other requirements as may be specified by the service recipient before the closing of the sales transaction. For this purpose, a customer is treated as an unrelated customer only if the customer is not related to either the service provider or the service recipient. A person is treated as related to another person if the person would be treated as related to the other person under §1.409A-1(f)(2)(ii) or the person would be treated as providing management services to the other person under §1.409A-1(f)(2)(iv).

(ii) *Investment commission compensation.* For purposes of this paragraph (a), a service provider earning investment commission compensation is treated as providing the services to which such compensation relates over the 12 months preceding the date as of which the overall value of the assets or asset accounts is determined for purposes of the calculation of the investment commission compensation. For purposes of this paragraph (a)(12), the term *investment commission compensation* means the compensation or the portion of compensation earned by a service provider if a substantial portion of the services provided by such service provider to a service recipient to which such compensation relates consists of sales of financial products or other direct customer services to an unrelated customer with respect to customer assets or customer asset accounts, the customer retains the right to terminate the customer relationship and may move or liquidate the assets or asset accounts without undue delay (which may be subject to a reasonable notice period), such compensation consists of a portion of the value of the overall assets or asset account balance, an amount substantially all of which is calculated by reference to the increase in the value of the overall assets or account balance during a specified period, or both, and

the value of the overall assets or account balance and investment commission compensation is determined at least annually. For this purpose, a customer is treated as an unrelated customer only if the customer is not related to either the service provider or the service recipient. A person is treated as related to another person if the person would be treated as related to the other person under §1.409A-1(f)(2)(ii) or the person would be treated as providing management services to the other person under §1.409A-1(f)(2)(iv).

(iii) *Commission compensation and related persons.* The rules of paragraphs (a)(12)(i) and (ii) of this section apply to sales commission compensation and investment commission compensation involving a related customer, provided that substantial sales from which commission compensation arises are made, or substantial services from which commission compensation arises are provided, to unrelated customers by the service recipient, the sales and service arrangement and the commission arrangement with respect to the related customer are *bona fide*, arise from the service recipient's ordinary course of business, and are substantially the same, both in terms and in practice, as the terms and practices applicable to unrelated customers (as defined in such paragraphs) to which individually or in the aggregate substantial sales are made or substantial services provided by the service recipient.

(13) *Initial deferral election with respect to compensation paid for final payroll period—(i) In general.* Unless a plan provides otherwise, compensation payable after the last day of the service provider's taxable year solely for services performed during the final payroll period described in section 3401(b) containing the last day of the service provider's taxable year or, with respect to a non-employee service provider, a period not longer than the payroll period described in section 3401(b), where such amount is payable pursuant to the timing arrangement under which the service recipient normally compensates service providers for services performed during a payroll period described in section 3401(b), or with respect to a non-employee service provider, a period not longer than the payroll period described in section 3401(b), is treated as compensation for services performed in

the subsequent taxable year in which the payment is made. The preceding sentence does not apply to any compensation paid during such period for services performed during any period other than such final payroll period, such as a payment of an annual bonus. Any amendment of a plan after December 31, 2007, to add a provision providing for a differing treatment of such compensation may not be effective for 12 months from the date the amendment is executed and enacted.

(ii) *Transition rule.* For purposes of this paragraph (a)(13), a plan that was adopted and effective before December 31, 2007, whether written or unwritten, will be treated as designating such compensation for services performed in the taxable year in which the payroll period ends, unless otherwise set forth in writing before December 31, 2007.

(14) *Elections to annualize recurring part-year compensation.* In the case of a service provider receiving recurring part-year compensation, an election to defer all or a portion of the recurring part-year compensation to be earned during a particular service period is considered to meet the requirements of this paragraph (a) if the election is made before the services for which the recurring part-year compensation is paid begin, and the election does not defer payment of any of the recurring part-year compensation to a date beyond the last day of the 13th month following the first date of the service period. For purposes of this paragraph (a)(14), the term *recurring part-year compensation* means compensation paid for services rendered in a position that the service recipient and service provider reasonably anticipate will continue on similar terms and conditions in subsequent years, and will require services to be provided during successive service periods each of which comprises less than 12 months (for example, a teacher providing services during a school year comprised of 10 consecutive months), and each of which periods begins in one taxable year of the service provider and ends in the next such taxable year. The rules of this paragraph (a)(14) apply to a particular amount of compensation only once, so that an amount deferred under this rule may not again be treated as recurring part-year compensation for purposes of this paragraph and subject to a second deferral election under this paragraph (a)(14).

(15) *USERRA rights.* The requirements of this paragraph (a) are deemed satisfied to the extent an initial deferral election is provided to satisfy the requirements of the Uniformed Service Employment and Reemployment Rights Act of 1994, as amended, 38 U.S.C. 4301-4334.

(b) *Subsequent changes in time and form of payment—(1) In general.* A plan that permits under a subsequent election a delay in a payment or a change in the form of payment (a subsequent deferral election), including a subsequent deferral election made by a service provider or a service recipient, satisfies the requirements of section 409A(a)(4)(C) only if the conditions of this paragraph (b) are met. For purposes of this paragraph (b), except as otherwise expressly provided in this section, a subsequent deferral election is not considered made until such election becomes irrevocable under the terms of the plan. Accordingly, a plan may provide that a subsequent deferral election may be changed at any time before the last permissible date for making such a subsequent deferral election. Where a plan permits a subsequent deferral election, the requirements of this paragraph are satisfied only if the following conditions are met:

(i) The plan requires that such 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 not described in §1.409A-3(a)(2) (payment on account of disability), §1.409A-3(a)(3) (payment on account of death), or §1.409A-3(a)(6) (payment on account of the occurrence of an unforeseeable emergency), the plan requires that the payment with respect to which such election is made be deferred for a period of not less than five years from the date such payment would otherwise have been paid (or in the case of a life annuity or installment payments treated as a single payment, five years from the date the first amount was scheduled to be paid).

(iii) The plan requires that any election related to a payment described in §1.409A-3(a)(4) (payment at a specified time or pursuant to a fixed schedule) be made not less than 12 months before the date the payment is scheduled to be paid (or in the case of a life annuity or installment payments treated as a single payment, 12 months before the date the first amount was scheduled to be paid).

(2) *Definition of payments for purposes of subsequent changes in the time or form of payment*—(i) *In general.* Except as provided in paragraphs (b)(2)(ii) and (iii) of this section, the term *payment* refers to each separately identified amount to which a service provider is entitled to payment under a plan on a determinable date, and includes amounts applied for the benefit of the service provider. An amount is separately identified only if the amount may be objectively determined under a nondiscretionary formula. For example, an amount identified as 10 percent of the account balance as of a specified payment date would be a separately identified amount. A payment includes the provision of any taxable benefit, including payment in cash or in kind. In addition, a payment includes, but is not limited to, the transfer, cancellation, or reduction of an amount of deferred compensation in exchange for benefits under a welfare benefit plan, a fringe benefit excludible under section 119 or section 132, or any other benefit that is excludible from gross income. For additional rules relating to the application of this paragraph (b) to amounts payable at a fixed time or pursuant to a fixed schedule, see §1.409A-3(i)(1).

(ii) *Life annuities*—(A) *In general.* The entitlement to a life annuity is treated as the entitlement to a single payment. Accordingly, an election to delay payment of a life annuity, or to change the form of payment of a life annuity, must be made at least 12 months before the scheduled commencement of the life annuity, and must defer the payment for a period of not less than five years from the originally scheduled commencement of the life annuity. For purposes of §1.409A-1, this section, and §§1.409A-3 through 1.409A-6, the term *life annuity* means a series of substantially equal periodic payments, payable not less frequently than annually, for the life (or life expectancy) of the service provider, or a series of substantially equal periodic payments, payable not less frequently than annually, for the life (or life expectancy) of the service provider, followed upon the death or end of the life expectancy of the service provider by a series of substantially equal periodic payments, payable not less frequently than annually, for the life (or life expectancy) of the service provider's designated beneficiary (if any). A change in designated beneficiary before any annuity

payment has been made under the plan is not a change in the time or form of payment. A change in the form of a payment before any annuity payment has been made under the plan, from one type of life annuity to another type of life annuity with the same scheduled date for the first annuity payment, is not considered a change in the time and form of a payment, provided that the annuities are actuarially equivalent applying reasonable actuarial methods and assumptions. For purposes of this paragraph (b)(2)(ii), a requirement that a service provider obtain the consent of a spouse or other potential recipient of a survivor annuity to change a beneficiary or form of payment is disregarded, so that any annuity form that the service recipient could elect to receive with such consent is considered currently available.

(B) *Certain features disregarded.* Notwithstanding the foregoing provisions of this paragraph (b)(2)(ii), the following features are disregarded for purposes of determining whether a payment form is a life annuity within the meaning of this paragraph (b)(2)(ii), but are not disregarded for purposes of determining whether a life annuity is the actuarial equivalent of another life annuity except as otherwise provided in this paragraph (b)(2)(ii):

(1) Term certain features under which annuity payments continue for the longer of the life of the annuitant or a fixed period of time.

(2) Pop-up features under which payments increase upon the death of the beneficiary or another event that eliminates the right to a survivor annuity.

(3) Cash refund features under which payment is provided upon the death of the last annuitant in an amount that is not greater than the excess of the present value of the annuity at the annuity starting date over the total of payments before the death of the last annuitant.

(4) Features under which an annuity form of payment provides higher periodic payments before the expected commencement of benefits under the Social Security Act (42 U.S.C. ch. 7) or the Railroad Retirement Act (45 U.S.C. 231 *et. seq.*) and lower periodic payments after such expected commencement date, so that the combined periodic payments under the arrangement and the Social Security Act or the Railroad Retirement Act, as applicable,

are approximately level before and after such expected commencement date (Social Security or Railroad Retirement leveling features).

(5) Features providing for an increase in the annuity payment in a manner described in §1.401(a)(9)-6, Q&A-14(a)(1) or (2) (eligible cost-of-living adjustments).

(C) *Subsidized joint and survivor annuities.* For purposes of this paragraph (b)(2)(ii), a joint and survivor annuity will not fail to be treated as actuarially equivalent to a single life annuity due solely to the value of a subsidized survivor annuity benefit, provided that the annual lifetime annuity benefit available to the service provider under the joint and survivor annuity is not greater than the annual lifetime annuity benefit available to the service provider under the single life annuity alternative, and provided that the annual survivor annuity benefit is not greater than the annual lifetime annuity benefit available to the service provider under the joint and survivor annuity.

(D) *Actuarial assumptions and methods.* For purposes of this paragraph (b)(2)(ii), at any given time the same actuarial assumptions and methods must be used in valuing each annuity payment option, in determining whether the payments are actuarially equivalent and such assumptions must be reasonable. This requirement applies over the entire term of the service provider's participation in the plan, such that the annuity payment must be actuarially equivalent at all times for the annuity payment options to be treated as one time and form of payment. There is no requirement that the same actuarial methods and assumptions be used over the term of a service provider's participation in a plan. Accordingly, a plan may change the actuarial assumptions and methods used to determine the life annuity payments provided that all of the actuarial assumptions and methods are reasonable.

(iii) *Installment payments.* The entitlement to a series of installment payments that is not a life annuity is treated as the entitlement to a single payment, unless the plan provides at all times with respect to the amount deferred that the right to the series of installment payments is to be treated as a right to a series of separate payments. For purposes of §1.409A-1, this section, and §§1.409A-3 through 1.409A-6, a series of installment payments refers to an

entitlement to the payment of a series of substantially equal periodic amounts to be paid over a predetermined period of years, except to the extent any increase (or decrease) in the amount reflects reasonable earnings (or losses) through the date the amount is paid. For this purpose, a series of installment payments over a predetermined period and a series of installment payments over a shorter or longer period, or a series of installment payments over the same predetermined period but with a different commencement date, are different times and forms of payment. Accordingly, a change in the predetermined period or the commencement date is a change in the time and form of payment. Notwithstanding the foregoing, a schedule of payments does not fail to be an installment payment solely because such plan provides for an immediate payment of all remaining installments if the present value of the deferred amount to be paid in the remaining installment payments falls below a predetermined amount, and the immediate payment of such amount does not constitute an accelerated payment for purposes of §1.409A-3(j), provided that such feature including the predetermined amount is established by no later than the time and form of payment is otherwise required to be established, and provided further that any change in such feature including the predetermined amount is a change in the time and form of payment.

(iv) *Transition rule.* For purposes of this section, a plan that was adopted and effective before December 31, 2007, whether written or unwritten, that fails to make a designation as to whether the entitlement to a series of payments is to be treated as an entitlement to a series of separate payments under paragraph (b)(2)(iii) of this section, may make such designation on or before December 31, 2007, provided such designation is set forth in writing on or before December 31, 2007.

(3) *Beneficiaries.* The rules of this paragraph (b) governing changes in the time and form of payment apply to elections by beneficiaries with respect to the time and form of payment, as well as elections by service providers or service recipients with respect to the time and form of payment to beneficiaries. An election to change the identity of a beneficiary does not constitute a change in the time and form of payment merely because the election changes

the identity of the recipient of the payment, if the time and form of the payment is not otherwise changed. In addition, an election to change the identity of a beneficiary before the initial payment of a life annuity does not constitute a change in the time and form of payment if the change in the time of payments stems solely from the different life expectancy of the new beneficiary, such as in the case of a joint and survivor annuity.

(4) *Domestic relations orders.* The rules of this paragraph (b) governing changes in the time and form of payment do not apply to elections by individuals other than a service provider, with respect to payments to a person other than the service provider, to the extent such elections are reflected in, or made in accordance with, the terms of a domestic relations order (as defined in section 414(p)(1)(B)).

(5) *Coordination with prohibition against acceleration of payments.* For purposes of applying the prohibition against the acceleration of payments in §1.409A-3(j), the definition of payment is the same as the definition in paragraph (b)(2) of this section. Accordingly, a change in the form of a payment that results in a more rapid schedule for payments generally will not constitute an acceleration of a payment, if the change in the form of payment is made in compliance with the subsequent deferral rules. For example, a change in form from a 10-year installment payment treated as a single payment to a lump-sum payment would not constitute an acceleration if the change in the form of the payment is made in compliance with the requirements of paragraph (b)(1) of this section, generally meaning that the election to change to a lump-sum payment must be made at least 12 months before the installment payments were scheduled to commence and the lump-sum payment could not be made until at least five years after the date the installment payments were scheduled to commence. See §1.409A-3(j)(4)(i) with respect to situations in which the failure to accelerate a payment or the modification of a plan term relating to certain accelerated payments will not be subject to the rules of this paragraph (b).

(6) *Application to multiple payment events.* In the case of a plan that permits a payment upon each of a number of potential permissible payment events, such

as the earlier of a fixed date or separation from service, the requirements of paragraph (b)(1) of this section are applied separately to each payment (as defined in paragraph (b)(2) of this section) due upon each payment event. Notwithstanding the foregoing, the addition or deletion of a permissible payment event to a plan under which amounts were previously deferred is subject to the rules of this paragraph (b) where the addition or deletion of the permissible payment event may result in a change in the time or form of payment of the amount deferred. For application of the rules governing accelerations of payments to the addition of a permissible payment event to amounts deferred, see §1.409A-3(j).

(7) *Delay of payments under certain circumstances.* A payment may be delayed to a date after the designated payment date under any of the circumstances described in this paragraph (b)(7), and the provision will not fail to meet the requirements of establishing a permissible payment event and the delay in the payment will not constitute a subsequent deferral election, so long as the service recipient treats all payments to similarly situated service providers on a reasonably consistent basis.

(i) *Payments subject to section 162(m).* A payment may be delayed to the extent that the service recipient reasonably anticipates that if the payment were made as scheduled, the service recipient's deduction with respect to such payment would not be permitted due to the application of section 162(m), provided that the payment is made either during the service provider's first taxable year in which the service recipient reasonably anticipates, or should reasonably anticipate, that if the payment is made during such year, the deduction of such payment will not be barred by application of section 162(m) or during the period beginning with the date of the service provider's separation from service and ending on the later of the last day of the taxable year of the service recipient in which the service provider separates from service or the 15th day of the third month following the service provider's separation from service, and provided further that where any scheduled payment to a specific service provider in a service recipient's taxable year is delayed in accordance with this paragraph, the delay in payment will

be treated as a subsequent deferral election unless all scheduled payments to that service provider that could be delayed in accordance with this paragraph are also delayed. Where the payment is delayed to a date on or after the service provider's separation from service, the payment will be considered a payment upon a separation from service for purposes of the rules under §1.409A-3(i)(2) (payments to specified employees upon a separation from service) and, in the case of a specified employee, the date that is six months after a service provider's separation from service is substituted for any reference to a service provider's separation from service in the first sentence of this paragraph. No election may be provided to the service provider with respect to the timing of the payment under this paragraph (b)(7)(i).

(ii) *Payments that would violate Federal securities laws or other applicable law.* A payment may be delayed where the service recipient reasonably anticipates that the making of the payment will violate Federal securities laws or other applicable law; provided that the payment is made at the earliest date at which the service recipient reasonably anticipates that the making of the payment will not cause such violation. The making of a payment that would cause inclusion in gross income or the application of any penalty provision or other provision of the Internal Revenue Code is not treated as a violation of applicable law.

(iii) *Other events and conditions.* A service recipient may delay a payment upon such other events and conditions as the Commissioner may prescribe in generally applicable guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter). For additional rules applicable to certain delayed payments pursuant to a change in control event, see §1.409A-3(i)(5)(iv). For additional rules applicable to amounts payable because of an unforeseeable emergency, see §1.409A-3(i)(3).

(8) *USERRA rights.* The requirements of this paragraph (b) are deemed met to the extent an election to change the time or form of a payment of deferred compensation is provided to satisfy the requirements of the Uniformed Services Employment and Reemployment Rights Act of 1994, as amended, 38 U.S.C. 4301-4344.

(9) *Examples.* The following examples illustrate the application of the provisions

of this section. For purposes of these examples, each employee is an individual with a calendar year taxable year, and is employed by the specified employer:

Example 1. Initial election to defer salary. Employer ZZ sponsors a plan under which Employee A may elect to defer a percentage of Employee A's salary. Employee A has participated in the plan in prior years. To satisfy the requirements of this section with respect to salary earned in calendar year 2008, if Employee A elects to defer any amount of such salary, the deferral election (including an election as to the time and form of payment) must be made no later than December 31, 2007.

Example 2. Designation of time and form of payment where an initial deferral election is not provided. Employer YY has a taxable year ending September 30. On July 1, 2008, Employer YY enters into a legally binding obligation to pay Employee B a \$10,000 bonus. The amount is not subject to a substantial risk of forfeiture and does not qualify as performance-based compensation as described in §1.409A-1(e). Employer YY does not provide Employee B an election as to the time and form of payment. Unless the amount is to be paid in accordance with the short-term deferral rule of §1.409A-1(b)(4), Employer YY must specify the time and form of payment on or before July 1, 2008, to satisfy the requirements of this section.

Example 3. Initial election to defer bonus payable based on services during calendar year. Employer XX has a taxable year ending September 30. Employee C participates in a bonus plan under which Employee C is entitled to a bonus for services performed during the calendar year that, absent an election by Employee C, will be paid on March 15 of the following year. The amount is not subject to a substantial risk of forfeiture and does not qualify as performance-based compensation as described in §1.409A-1(e). If Employee C elects to defer the payment of the bonus with respect to services rendered during calendar year 2008, Employee C must elect the time and form of payment not later than December 31, 2007, to satisfy the requirements of this section.

Example 4. Initial election to defer bonus payable based on services during fiscal year other than calendar year. Employer WW has a taxable year ending September 30. Employee D participates in a bonus plan under which Employee D is entitled to a bonus for services performed during Employer WW's fiscal year that, absent an election by Employee D, will be paid on December 15 of the calendar year in which the fiscal year ends. The amount is not subject to a substantial risk of forfeiture and does not qualify as performance-based compensation as described in §1.409A-1(e). The amount qualifies as fiscal year compensation. If Employee D elects to defer the payment of the amount related to the fiscal year ending September 30, 2009, to satisfy the requirements of this section Employee D must elect the time and form of payment not later than September 30, 2008.

Example 5. Initial election to defer bonus payable only if service provider completes at least 12 months of services after the election. Employer VV has a calendar year taxable year. On March 1, 2008, Employer VV grants Employee E a \$10,000 bonus, payable on March 1, 2010 (with reasonable interest), provided that Employee E continues performing services as an

employee of Employer VV through March 1, 2010. The amount does not qualify as performance-based compensation as described in §1.409A-1(e), and Employee E already participates in another account balance nonqualified deferred compensation plan. Employee E may make an initial deferral election on or before March 31, 2008 (within 30 days after obtaining a legally binding right), because at least 12 months of additional services are required after the date of election for the risk of forfeiture to lapse.

Example 6. Initial election to defer bonus that would otherwise constitute a short-term deferral. The same facts as *Example 5*, except that Employee E does not make an initial deferral election on or before March 31, 2008. Because the right to the compensation would not be treated as a deferral of compensation pursuant to §1.409A-1(b)(4) absent a deferral election (because the arrangement would be treated as a short-term deferral), Employee E may make an initial deferral election provided that the election may not become effective for 12 months and must defer the payment at least 5 years from March 1, 2010 (the first date the payment could become substantially vested). Accordingly, Employee E may make an election before March 1, 2009, provided that the election defers the payment to a date on or after March 1, 2015 (other than a payment due to death, disability, unforeseeable emergency, or a change in control event).

Example 7. Initial election to defer sales commissions. Employer UU has a calendar year taxable year. As part of Employee F's services for Employer UU, Employee F sells refrigerators to customers unrelated to Employee F or Employer UU. Under the employment arrangement, Employee F is entitled to 10% of the sales price of any refrigerator Employee F sells, payable only upon the receipt of payment from the customer who purchased the refrigerator. For purposes of the initial deferral rule, Employee F is treated as performing the services related to each refrigerator sale in the calendar year in which each customer pays for the refrigerator.

Example 8. Initial election to defer renewal sales commissions. The same facts as *Example 7*, except that Employee F also sells warranties related to the refrigerators sold. Under the warranty arrangement, refrigerator warranty customers are entitled in a future year to extend the warranty for an additional cost to be paid at the time of the extension. Under Employee F's arrangement with Employer UU, Employee F is entitled to 10% of the amount paid for an extension of any warranty, payable upon the receipt of payment from the customer extending the warranty. For purposes of the initial deferral election rule, Employee F is treated as performing the services related to the amount paid for the extension of the warranty in the taxable year in which the customer pays for the warranty extension.

Example 9. Initial election to defer investment commissions. Employer TT is in the trade or business of managing financial assets for customer accounts. Customers who deposit funds in an account with Employer TT are entitled to remove the account balance of such account upon 60 days notice to Employer TT. Employee G sells financial products and provides continuing customer service to certain unrelated customers involving the deposit and maintenance of funds in customer accounts managed by Employer TT. Under the employment arrangement, Em-

Employee G is entitled to a set percentage of the aggregate value of the assets held in the accounts of customers to whom Employee G sold financial products and provides customer service. Under the arrangement, the aggregate value of the assets held in the accounts is determined as of June 30 of each year, and unless Employee G elects to defer the payment, the amount is payable to Employee G in a lump sum on December 31 of the year in which the valuation is made. Employee G has no control over the valuation of the assets held in the accounts, or the calculation of the amount due Employee G. For purposes of the initial deferral rule, Employee G is treated as providing the services to which a payment relates during the July 1 through June 30 period ending on the June 30 date as of which the assets held in the account are valued.

Example 10. Initial election to defer part-year compensation. Employee H provides services as a teacher to Employer SS, a school system. The period of services routinely begins on the second Monday of August of one year and ends on the first Friday of June of the subsequent year. Employer SS provides an election to Employee H to receive the compensation for the period of services ratably over the period beginning on the second Monday of August of one year and ending on the last day of August of the subsequent year. Because the compensation constitutes recurring part-year compensation, as defined in paragraph (a)(14) of this section, and because the schedule will provide that all of the recurring part-year compensation is paid no later than September 30 of the subsequent year, Employee H will be deemed to have made a timely deferral election with respect to such recurring part-year compensation if Employee H elects before the first day of the service period to have the recurring part-year compensation paid under such schedule.

Example 11. Initial election to defer negotiated separation pay. Employer RR decides to terminate Employee J's employment involuntarily. As part of the process of terminating Employee J, Employer RR enters into *bona fide*, arm's length negotiations with respect to the terms of Employee J's termination of employment. As part of the process, Employer RR offers Employee J an amount that is in addition to any amounts to which Employee J is otherwise entitled, payable either as a lump sum payment at the end of 3 years or in 3 annual payments starting at the date of termination of employment. The election of the time and form of payment by Employee J may be made at any time before Employee J accepts the offer and obtains a legally binding right to the additional amount. The election may not apply to any amount to which Employee J already had a legally binding right.

Example 12. Election of time and form of payments under a window program. Employer QQ establishes a window program, as defined in §1.409A-1(b)(9)(vi). Individuals who elect to terminate employment under the window program are entitled to receive an amount equal to 2 weeks pay multiplied by every year of service with Employer QQ. The individuals participating in the window program may elect to receive the payment as either a lump sum payment payable on the first day of the month after making the election to participate in the window program, or as a payment of 3 equal annual installments on each January 1 of the first 3 years

following the election to participate in the window program. Employee K is eligible to participate in the window program. Employee K will be treated as making a timely deferral election if the election as to the time and form of payment is made on or before the date Employee K's election to participate in the window program becomes irrevocable.

Example 13. Initial election to defer salary earned during final payroll period beginning in one calendar year and ending in the subsequent calendar year. Employer PP pays the salary of its employees, including Employee L, on a bi-weekly basis. One bi-weekly payroll period runs from December 24, 2008, through January 6, 2009, with a scheduled payment date of January 13, 2009. Employer PP sponsors, and Employee L participates in, a nonqualified deferred compensation plan under which Employee L may defer a specified percentage of his annual salary. The plan does not specify that any salary compensation paid for the payroll period in which falls January 1 is to be treated as compensation for services performed during the year preceding the year in which falls that January 1. For purposes of applying the initial deferral election rules, Employee L is deemed to have performed the services for the payroll period December 24, 2008, through January 6, 2009, during the calendar year 2009.

Example 14. Application of deferral election rules and anti-acceleration rules to a nonqualified deferred compensation plan linked to a qualified plan. Employee M participates in a qualified retirement plan that is a defined benefit plan that offers a subsidized early retirement benefit to employees who have attained age 55 and completed 30 years of service. Employee M, who has attained age 55 and completed 30 years of service, also participates in a nonqualified deferred compensation plan, under which the benefit payable is calculated under a formula, with that benefit then reduced by any benefit that Employee M has accrued under the qualified retirement plan. In 2008, Employee M fails to elect the subsidized early retirement benefit under the qualified retirement plan, with the effect that the amounts payable under the nonqualified deferred compensation plan are increased by an amount equal to the reduction in the benefit payable under the qualified plan. In 2009, Employer NN amends the qualified retirement plan to increase benefits under the plan, resulting in a decrease in the amounts payable under the nonqualified deferred compensation plan equal to the increase in the benefit payable under the qualified plan. Neither of these actions constitutes a deferral election or an acceleration of a payment under the nonqualified deferred compensation plan.

Example 15. Subsequent deferral election. Employee N participates in a nonqualified deferred compensation plan. Employee N elects to be paid in a lump sum payment at the earlier of age 65 or separation from service. Employee N anticipates that he will work after age 65, and wishes to defer payment to a later date. Provided that Employee N continues in employment and makes the election by his 64th birthday, Employee N may elect to receive a lump sum payment at the earlier of age 70 or separation from service.

Example 16. Subsequent deferral election rule – change in form of payment from lump sum payment to life annuity. Employee P participates in a nonqualified deferred compensation plan. Employee P elects

to be paid in a lump sum payment at age 65. Employee P wishes to change the payment form to a life annuity. Provided that Employee P makes the election on or before his 64th birthday, Employee P may elect to receive a life annuity commencing at age 70.

Example 17. Subsequent deferral election rule – change in form of payment from life annuity to lump sum payment. Employee Q participates in a nonqualified deferred compensation plan. Employee Q elects to be paid in a life annuity at age 65. Employee Q wishes to change the payment form to a lump sum payment. Provided that Employee Q makes the election on or before his 64th birthday, Employee Q may elect to receive a lump sum payment at age 70.

Example 18. Subsequent deferral election rule – installment payments designated as separate payments. Employee R, whose taxable year is the calendar year, participates in a nonqualified deferred compensation plan that provides for payment in a series of 5 equal annual amounts, each designated as a separate payment. The first payment is scheduled to be made on January 1, 2010. Provided that Employee R makes the election on or before January 1, 2009, Employee R may elect for the first payment scheduled to be made on January 1, 2010, to be made on January 1, 2015. If Employee R makes that election, but does not elect to defer the remaining payments, the remaining payments continue to be due upon January 1 of the 4 consecutive calendar years commencing on January 1, 2011.

Example 19. Subsequent deferral election rule – change in form of payment from installment payments not designated as separate payments to lump sum payment. Employee S participates in a nonqualified deferred compensation plan that provides for payment in a series of 5 equal annual amounts that are not designated as a series of 5 separate payments. The first amount is scheduled to be paid on January 1, 2010. Employee S wishes to receive the entire amount equal to the sum of all 5 of the amounts to be paid as a lump sum payment. Provided that Employee S makes the election on or before January 1, 2009, Employee S may elect to receive a lump sum payment on or after January 1, 2015.

Example 20. Subsequent deferral election rule – change in form of payment from installment payments designated as separate payments to lump sum payment. Employee T participates in a nonqualified deferred compensation plan that provides for payment in a series of 5 equal annual amounts each of which is designated as a separate payment. The first amount is scheduled to be paid on January 1, 2010. Employee T wishes to receive the entire amount equal to the sum of all 5 of the amounts in a single lump sum payment. Provided that Employee T makes the election on or before January 1, 2009, Employee T may elect to receive a lump sum payment on or after January 1, 2019.

Example 21. Subsequent deferral election rule – change in form of payment from one life annuity form to another life annuity form. Employee U participates in a nonqualified deferred compensation plan that permits Employee U to elect before Employee U's separation from service whether to be paid in the form of a single life annuity beginning on the first day of the month following Employee U's separation from service, or an annuity beginning on the first day of the month following Employee U's separation from service under which annuity payments

continue for Employee U's lifetime but not less than 10 years. The two types of annuities are actuarially equivalent at all times applying reasonable actuarial methods and assumptions. For purposes of this section, the two types of annuities are treated as a single form of payment. Accordingly, the election provided under the plan is not treated as providing a subsequent deferral election or accelerated payment, and an election by Employee U under the plan between the two annuity options made before the first scheduled payment date for an annuity payment is not treated as a subsequent deferral election or an acceleration of a payment.

Example 22. Subsequent deferral election rule – change in time of payment from payment at specified age to payment at later of specified age or separation from service. Employee V participates in a nonqualified deferred compensation plan that provides for a lump sum payment at age 65. Employee V wishes to modify the plan so that the deferred amount will be payable upon the later of Employee V's attainment of a specified age or separation from service. Provided that Employee V makes such election on or before his 64th birthday, Employee V may modify the plan so Employee V will receive a lump sum payment upon the later of age 70 or separation from service.

Example 23. Subsequent deferral election rule – change in time of payment from payment at separation from service to payment at later of separation from service or specified age. Employee W participates in a nonqualified deferred compensation plan that provides for a lump sum payment at separation from service. Employee W wishes to make the payment payable upon the later of separation from service or a predetermined age. Provided that Employee W makes such election on or before the date 1 year before a separation from service, Employee W may elect to receive a lump sum payment upon the later of the date 5 years following a separation from service or at a specified age.

Example 24. Subsequent deferral election rule – change in time of payment from payment at separation from service to payment at a change in control event. Employee X participates in a nonqualified deferred compensation plan that provides for a lump sum payment at separation from service. Employee X wishes to change the payment provision such that the payment is payable upon a change in control event. A change in the distribution provision to provide for a payment only upon a change in control event will violate the rules governing payment provisions, because the change could result in an acceleration if the change in control event occurs before Employee X separates from service, or a subsequent deferral if the change in control does not occur until after Employee X separates from service. However, provided that Employee X makes such election on or before the date 1 year before a separation from service, Employee X may elect to receive a payment upon the later of a change in control event or 5 years following a separation from service.

(c) *Special rules for certain resident aliens.* For the first taxable year of an individual in which such individual is a resident alien, a nonqualified deferred compensation plan is deemed to meet the requirements of paragraph (a) of this section if, with respect to compensation payable

for services performed during that first taxable year or with respect to compensation the right to which is subject to a substantial risk of forfeiture as of the first day of that first taxable year, an initial deferral election is made by the end of such first taxable year, provided that the initial deferral election may not apply to amounts that have already been paid or made available to the service provider before the election is made. For any year after the first taxable year in which an individual is classified as a resident alien, this paragraph (c) does not apply, provided that a taxable year may again be treated as the first taxable year in which an individual is classified as a resident alien if such individual is classified as a resident alien in that taxable year and has not been classified as a resident alien for the three consecutive taxable years immediately preceding that taxable year.

§1.409A–3 Permissible payments.

(a) *In general.* The requirements of section 409A(a)(2)(A) are met only if the plan provides that an amount of deferred compensation under the plan may be paid only upon an event or at a time set forth in this paragraph (a):

(1) The service provider's separation from service (as defined in §1.409A–1(h) and in accordance with paragraph (i)(2) of this section).

(2) The service provider becoming disabled (in accordance with paragraph (i)(4) of this section).

(3) The service provider's death.

(4) A time or a fixed schedule specified under the plan (in accordance with paragraph (i)(1) of this section).

(5) 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 (in accordance with paragraph (i)(5) of this section).

(6) The occurrence of an unforeseeable emergency (in accordance with paragraph (i)(3) of this section).

(b) *Designation of payment upon a permissible payment event.* Except as otherwise specified in this section, a plan provides for the payment upon an event described in paragraph (a)(1), (2), (3), (5), or (6) of this section if the plan provides the date of the event is the payment date, or specifies another payment date that is objectively determinable and nondiscre-

tionary at the time the event occurs. A plan may also provide that a payment upon an event described in paragraph (a)(1), (2), (3), (5), or (6) of this section is to be made in accordance with a schedule that is objectively determinable and nondiscretionary based on the date the event occurs and that would qualify as a fixed schedule under paragraph (i)(1) of this section if the payment event were instead a fixed date, provided that the schedule must be fixed at the time the permissible payment event is designated. In addition, a plan may provide that a payment, including a payment that is part of a schedule, is to be made during a designated taxable year of the service provider that is objectively determinable and nondiscretionary at the time the payment event occurs such as, for example, a schedule of three substantially equal payments payable during the first three taxable years following the taxable year in which a separation from service occurs. A plan may also provide that a payment, including a payment that is part of a schedule, is to be made during a designated period objectively determinable and nondiscretionary at the time the payment event occurs, but only if the designated period both begins and ends within one taxable year of the service provider or the designated period is not more than 90 days and the service provider does not have a right to designate the taxable year of the payment (other than an election that complies with the subsequent deferral election rules of §1.409A–2(b)). Where a plan provides for a period of more than one day following a payment event during which a payment may be made, such as within 90 days following the date of the event, the payment date for purposes of the subsequent deferral rules under §1.409A–2(b) is treated as the first possible date upon which a payment could be made under the terms of the plan. A plan may provide for payment upon the earliest or latest of more than one event or time, provided that each event or time is described in paragraphs (a)(1) through (6) of this section. For examples illustrating the provisions of this paragraph, see paragraph (i)(1)(vi) of this section.

(c) *Designation of alternative specified dates or payment schedules based upon date of permissible event.* Except as otherwise provided in this paragraph (c), a plan may designate only one time and form

of payment upon the occurrence of each event described in paragraph (a)(1), (2), (3), (5), or (6) of this section. For example, a plan does not satisfy the requirements of this paragraph (c) if it provides for one payment date or schedule of payments if a specified event occurs on a Monday, but another payment date or schedule of payments if the event occurs on any other day of the week. However, a plan that provides for a payment upon an event described in paragraph (a)(2), (3), (5), or (6) of this section may allow for an alternative payment schedule if the event occurs on or before one (but not more than one) specified date, provided that the addition or deletion of such a different time and form of payment applicable to an existing deferral is subject to §1.409A-2(b) (subsequent deferral elections) and paragraph (j) of this section (accelerated payments). For example, a plan may provide that a service provider will receive a lump sum payment of the service provider's entire benefit under the plan on the first day of the month following a change in control event that occurs before the service provider attains age 55, but will receive 5 substantially equal annual payments commencing on the first day of the month following a change in control event that occurs on or after the service provider attains age 55. In the case of a plan that provides that a payment upon an event described in paragraph (a)(1) of this section (a payment upon a separation from service), a different time and form of payment may be designated with respect to a separation from service under each of the following conditions, provided that the addition or deletion of such a different time and form of payment applicable to an existing deferral is subject to §1.409A-2(b) and paragraph (j) of this section:

(1) A separation from service during a limited period of time not to exceed two years following a change in control event (as defined in paragraph (i)(5) of this section).

(2) A separation from service before or after a specified date (for example, the attainment of a specified age), or a separation from service before or after a combination of a specified date, such as attaining a specified age, and a specified period of service determined under a predetermined, nondiscretionary, objective formula or pursuant to the method for cred-

iting service under a qualified plan sponsored by the service recipient.

(3) A separation from service not described in paragraphs (c)(1) or (c)(2) of this section.

(d) *When a payment is treated as made upon the designated payment date.* Except as otherwise specified in this section, a payment is treated as made upon the date specified under the plan (including a date specified under paragraph (a)(4) of this section) if the payment is made at such date or a later date within the same taxable year of the service provider or, if later, by the 15th day of the third calendar month following the date specified under the plan and the service provider is not permitted, directly or indirectly, to designate the taxable year of the payment. In addition, a payment is treated as made upon the date specified under the plan (including a date specified under paragraph (a)(4) of this section) and is not treated as an accelerated payment if the payment is made no earlier than 30 days before the designated payment date and the service provider is not permitted, directly or indirectly, to designate the taxable year of the payment. For purposes of this paragraph, if the date specified is only a designated taxable year of the service provider, or a period of time during such a taxable year, the date specified under the plan is treated as the first day of such taxable year or the first day of the period of time during such taxable year, as applicable. The payment with respect to a stock right generally occurs upon the exercise of the stock right, so that where a stock right designates a fixed exercise date, the stock right will be deemed to have been paid at such date if the exercise and payment occur on such date or a later date within the same taxable year of the service provider or, if later, by the 15th day of the third calendar month following the exercise date specified under the plan. If calculation of the amount of the payment is not administratively practicable due to events beyond the control of the service provider (or service provider's beneficiary), the payment will be treated as made upon the date specified under the plan if the payment is made during the first taxable year of the service provider in which the calculation of the amount of the payment is administratively practicable. For purposes of this paragraph, the inability of a service recipient to calculate

the amount or timing of a payment due to a failure of a service provider (or service provider's beneficiary) to provide reasonably available information necessary to make such calculation does not constitute an event beyond the control of the service provider. Similarly, if the making of the payment at the date specified under the plan would jeopardize the ability of the service recipient to continue as a going concern, the payment will be treated as made upon the date specified under the plan if the payment is made during the first taxable year of the service provider in which the making of the payment would not have such effect.

(e) *Designation of time and form of payment with respect to earnings.* A non-qualified deferred compensation plan that provides for actual or notional earnings to be credited on amounts of deferred compensation may specify, in accordance with the requirements of §1.409A-2(a) (initial deferral elections), that such earnings are treated separately from the right to the other amounts deferred under the plan for purposes of designating the time and form of payments under such plan, provided that to satisfy the requirements of this paragraph (e), actual or notional earnings must be credited at least annually. For these purposes, a right to dividend equivalents may be treated analogously to a right to actual or notional earnings on an amount of deferred compensation. For purposes of this paragraph (e), the term *dividend equivalents* means the right to an amount equal to all or a specified portion of dividends declared and paid, if any, on a specified number of shares of stock.

(f) *Substitutions.* Except as otherwise provided under these regulations, the payment of an amount as a substitute for a payment of deferred compensation will be treated as a payment of the deferred compensation. A forfeiture or voluntary relinquishment of an amount of deferred compensation will not be treated as a payment of the compensation, but there is no forfeiture or voluntary relinquishment for this purpose if an amount is paid, or a legally binding right to a payment is created, that acts as a substitute for the forfeited or voluntarily relinquished amount. Whether a payment or a right to a payment acts as a substitute for a payment of deferred compensation is determined based on all the facts and circumstances. How-

ever, where the payment of an amount results in an actual or potential reduction of, or current or future offset to, an amount of deferred compensation, or if the service provider receives a loan the repayment of which is secured by or may be accomplished through an offset of or a reduction in an amount deferred under a nonqualified deferred compensation plan, the payment or loan is a substitute for the deferred compensation. In addition, where a service provider's right to deferred compensation is made subject to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, or garnishment by creditors of the service provider or the service provider's beneficiary, the deferred compensation is treated as having been paid. For the treatment of certain offsets, see paragraph (j)(4)(xiii) of this section. Even where there is no explicit reduction or offset, the payment of an amount or creation of a new right to a payment proximate to the purported forfeiture or voluntary relinquishment of a right to deferred compensation is presumed to be a substitute for the deferred compensation. The presumption is rebuttable by a showing that the compensation paid would have been received regardless of the forfeiture or voluntary relinquishment of the right to deferred compensation. Factors indicating that a payment would have been received regardless of such forfeiture or voluntarily relinquishment include that the amount paid is materially less than the forfeited or relinquished amount, or consists of a type of payment customarily made in the ordinary course of business of the service recipient to service providers who do not forfeit or relinquish deferred compensation (for example, a payment of accrued but unused leave or a payment for a release of actual or potential claims). See §1.409A-1(b)(9)(i) with respect to certain separation pay plans.

(g) *Disputed payments and refusals to pay.* If a service recipient fails to make a payment in whole or in part as of the date specified under a plan, either intentionally or unintentionally, other than with the express or implied consent of the service provider, the payment will be treated as made upon the date specified under the plan if the service provider accepts the portion (if any) of the payment that the service recipient is willing to make (unless such acceptance will result in a relinquish-

ment of the claim to all or part of the remaining amount), makes prompt and reasonable, good faith efforts to collect the remaining portion of the payment, and any further payment (including payment of a lesser amount that satisfies the obligation to make the payment) is made no later than the end of the first taxable year of the service provider in which the service recipient and the service provider enter into a legally binding settlement of such dispute, the service recipient concedes that the amount is payable, or the service recipient is required to make such payment pursuant to a final and nonappealable judgment or other binding decision. For purposes of this paragraph (g), efforts to collect the payment will be presumed not to be prompt, reasonable, good faith efforts, unless the service provider provides notice to the service recipient within 90 days of the latest date upon which the payment could have been timely made in accordance with the terms of the plan and these regulations, and unless, if not paid, the service provider takes further enforcement measures within 180 days after such latest date. For purposes of this paragraph (g), a service recipient is not treated as having failed to make a payment where pursuant to the terms of the plan the service provider is required to request payment, or otherwise provide information or take any other action, and the service provider has failed to take such action. In addition, for purposes of this paragraph (g), the service provider is deemed to have requested that a payment not be made, rather than the service recipient having failed to make such payment, where the service recipient's decision to refuse to make the payment is made by the service provider or a member of the service provider's family (as defined in section 267(c)(4) applied as if the family of an individual includes the spouse of any member of the family), or any person or group of persons over whom the service provider or service provider's family member has effective control, or any person any portion of whose compensation is controlled the service provider or service provider's family member.

(h) *Special rule for certain resident aliens.* An agreement, method, program, or other arrangement that is, or constitutes part of, a nonqualified deferred compensation plan is deemed to meet the requirements of this section with respect

to any amount payable in the first taxable year of the service provider in which a service provider is a resident alien, and with respect to any amount payable in a subsequent taxable year if no later than the last day of the first taxable year of the service provider in which the service provider is a resident alien, the plan is amended as necessary so that the times and forms of payment of amounts payable in a subsequent year comply with the provisions of this section. For any year after the first taxable year of an individual in which the individual is a resident alien, this paragraph (h) does not apply, provided that a taxable year may again be treated as the first taxable year in which an individual is a resident alien if such individual has not been a resident alien for at least three consecutive taxable years immediately preceding the taxable year in which the service provider is again a resident alien.

(i) *Definitions and special rules—(1) Specified time or fixed schedule—(i) In general.* Amounts are payable at a specified time or pursuant to a fixed schedule if objectively determinable amounts are payable at a date or dates that are nondiscretionary and objectively determinable at the time the amount is deferred. An amount is objectively determinable for this purpose if the amount is specifically identified or if the amount may be determined at the time payment is due pursuant to an objective, nondiscretionary formula specified at the time the amount is deferred (for example, 50 percent of a specified account balance). Except as otherwise provided in paragraph (i)(1) of this section, an amount is not objectively determinable if the amount of the payment is based all or in part upon the occurrence of an event, including the consummation of a transaction by, or a payment of an amount to, a service recipient. If an amount is payable in a service provider's taxable year (or pursuant to a fixed schedule of taxable years of the service provider) that is designated at the time the amount is deferred and that is objectively determinable, the amount is treated as payable at a specified time (or pursuant to a fixed schedule), provided that for purposes of the application of the subsequent deferral rules contained in §1.409A-2(b), the specified time or fixed schedule of payments is deemed to refer to the first day of the relevant taxable year or years. A specified time or

fixed schedule also includes the designation at the time the amount is deferred of a defined period or periods within the service provider's taxable year or taxable years that are objectively determinable, provided that no such defined period may begin within one taxable year and end within another taxable year, and provided further that for purposes of the application of the subsequent deferral rules contained in §1.409A-2(b), the specified time or fixed schedule of payments is deemed to refer to the first day of the relevant period in which the payment will be made. A plan may provide that a payment upon the lapse of a substantial risk of forfeiture is to be made in accordance with a fixed schedule that is objectively determinable based on the date the substantial risk of forfeiture lapses (disregarding any discretionary acceleration of the lapse of the substantial risk of forfeiture), provided that the schedule must be fixed on the date the time and form of payment are designated, and any change in the fixed schedule will constitute a change in the time and form of payment. For example, a plan that provides for a bonus payment subject to the condition that the service provider complete three years of service, and subject to the further condition that such requirement of continued services will lapse upon the occurrence of an initial public offering, which condition if applied alone would constitute a substantial risk of forfeiture, may provide that a service provider is entitled to substantially equal payments on each of the first three anniversaries of the date the substantial risk of forfeiture lapses (the earlier of three years of service or the date of an initial public offering).

(ii) *Payment schedules with formula and fixed limitations*—(A) *Individual limitations*. A schedule of payments does not fail to be a fixed schedule of payments where the amount of a payment or payments that may be paid at a specified time or during a specified period is limited by an objective nondiscretionary formula or a specified amount that is not under the effective control of the service provider and is not subject to the exercise of discretion by the service recipient, where such limitation is established on or before the date the time and form of payment is otherwise required to be set under these regulations, and the plan specifies the

time and form of any payment that will be made or completed after its original payment date due to the application of the limitation. A change in the limitation or a change in the time and form of any payment that exceeds the limitation is subject to the requirements of §1.409A-2(b) (subsequent deferral elections) and paragraph (j) of this section (accelerated payments). For purposes of this paragraph, a plan provision that reduces a schedule of periodic payments on a dollar-for-dollar basis by the amount of Social Security payments received or receivable may be treated as a nondiscretionary, objective formula limitation, if such reduction does not otherwise affect the time of payment of the deferred compensation (other than a forfeiture due to the reduction), including changes based on the service provider's eligibility or elections related to Social Security benefits. Similarly, a plan provision that reduces a schedule of periodic payments on a dollar-for-dollar basis by the amount of *bona fide* disability pay (within the meaning of §1.409A-1(a)(5)) received or receivable may be treated as a nondiscretionary, objective formula limitation, if the disability payments are made pursuant to a plan sponsored by the service recipient that covers a substantial number of service providers and was established before the service provider became disabled, and if such reduction does not otherwise affect the time of payment of the deferred compensation (other than a forfeiture due to the reduction). Whether an amendment to, or other change in the benefit payable under, such *bona fide* disability plan results in an acceleration of a payment for purposes of paragraph (j) of this section or a subsequent election to delay the time or change the form of payment for purposes of §1.409A-2(b) is determined based on all of the relevant facts and circumstances.

(B) *Limitations on aggregate payments to all participants in substantially identical plans*. A schedule of payments does not fail to be a fixed schedule of payments where the amount of the aggregate payments that will be made during a specified period of time to all participants in substantially identical plans is limited by an objective nondiscretionary formula or specified amount that is not under the effective control of the service provider and is not subject to the exercise of discretion by the service recipient, where the limit is

established on or before the date the time and form of payment of the amount deferred is otherwise required to be set under these regulations, the method of allocating payments among the participants where there is an overall limitation on the aggregate amount that may be paid to a group of service providers during a specified period is an objective nondiscretionary allocation method that is not under the effective control of the service provider and is not subject to the exercise of discretion by the service recipient, the method is established on or before the date the time and form of payment of the amount deferred is otherwise required to be set, and the plan specifies the time and form of any payment of any amount that will be paid after its original payment date due to the application of the limitation. A change in the limitation or a change in the time and form of payment of any payment that is not otherwise made at the scheduled payment date due to application of the formula limitation is subject to the requirements of §1.409A-2(b) (subsequent deferral elections) and paragraph (j) of this section (accelerated payments).

(iii) *Payment schedules determined by timing of payments received by the service recipient*. A payment schedule determined by reference to the timing of payments received by the service recipient (not including payments from one entity to another entity where both entities are treated as part of a single service recipient), meets the requirements of a specified date or fixed schedule of payments if the following conditions are met:

(A) The payments due to the service recipient arise from *bona fide* and routine transactions in the ordinary course of business of the service recipient.

(B) The service provider does not have effective control of the service recipient, the person from whom such amounts are due, or the collection of any of the amounts due to the service recipient.

(C) The payment schedule provides an objective, nondiscretionary method of identification of the payments to the service recipient from which the amount of the payment from the service recipient to the service provider is determined.

(D) The payment schedule provides an objective, nondiscretionary schedule under which the payments will be made to the service provider.

(E) The payments to the service recipient from which the amount of the payments from service recipient to the service provider are determined result from sales of a type that the service recipient is in the trade or business of making and makes frequently, and either all such sales by the service recipient are taken into account for purposes of determining the payment to the service provider, or there is a legitimate, non-tax business reason for identifying the specific sales taken into account.

(iv) *Reimbursement or in-kind benefit plans*—(A) *General rule.* A plan that provides for reimbursements of expenses incurred by a service provider, or in-kind benefits, meets the requirements of a specified date or fixed schedule of payments with respect to such reimbursements or benefits if the following conditions are met:

(1) The plan provides an objectively determinable nondiscretionary definition of the expenses eligible for reimbursement or of the in-kind benefits to be provided.

(2) The plan provides for the reimbursement of expenses incurred or for the provision of the in-kind benefits during an objectively and specifically prescribed period (including the lifetime of the service provider).

(3) The plan provides that the amount of expenses eligible for reimbursement, or in-kind benefits provided, during a service provider's taxable year may not affect the expenses eligible for reimbursement, or in-kind benefits to be provided, in any other taxable year.

(4) The reimbursement of an eligible expense is made on or before the last day of the service provider's taxable year following the taxable year in which the expense was incurred.

(5) The right to reimbursement or in-kind benefits is not subject to liquidation or exchange for another benefit.

(B) *Medical reimbursement arrangements.* Notwithstanding the foregoing, an arrangement providing for the reimbursement of expenses referred to in section 105(b) will not be deemed to fail to meet the requirements of paragraph (i)(1)(iv)(A)(3) of this section solely because the arrangement provides for a limit on the amount of expenses that may be reimbursed under such arrangement over some or all of the period in which the

reimbursement arrangement remains in effect.

(v) *Tax gross-up payments.* A plan providing a right to a tax gross-up payment will be treated as providing for payment at a specified time or on a fixed schedule of payments if the plan provides that payment will be made, and the payment is made, by the end of the service provider's taxable year next following the service provider's taxable year in which the service provider remits the related taxes. For purposes of this paragraph (i)(1)(v), the term *tax gross-up payment* refers to a payment to reimburse the service provider in an amount equal to all or a designated portion of the Federal, state, local, or foreign taxes imposed upon the service provider as a result of compensation paid or made available to the service provider by the service recipient, including the amount of additional taxes imposed upon the service provider due to the service recipient's payment of the initial taxes on such compensation. In addition, a right to the reimbursement of expenses incurred due to a tax audit or litigation addressing the existence or amount of a tax liability, whether Federal, state, local, or foreign, satisfies the requirement of a fixed time and form of payment if the right to the reimbursement provides that payment will be made, and the payment is made, by the end of the service provider's taxable year following the service provider's taxable year in which the taxes that are the subject of the audit or litigation are remitted to the taxing authority, or where as a result of such audit or litigation no taxes are remitted, the end of the service provider's taxable year following the service provider's taxable year in which the audit is completed or there is a final and nonappealable settlement or other resolution of the litigation. Nothing in this paragraph (i)(1)(v) otherwise alters the application of section 409A to the underlying compensation arrangement or other arrangement that results in the taxes subject to the right to the tax gross-up payment.

(vi) *Examples.* The following examples (in which each employee is an individual whose taxable year is the calendar year) illustrate the principles of paragraphs (a), (b), (c), (d), and (i)(1) of this section:

Example 1. Employee A provides services as an employee of Employer Z, but is not a specified employee. Employee A participates in a nonqualified

deferred compensation plan providing for a lump sum payment payable on or before December 31 of the calendar year in which Employee A separates from service. The plan provides for a payment upon a separation from service in compliance with this section.

Example 2. Employee B provides services as an employee of Employer Y, but is not a specified employee. Employee B participates in a nonqualified deferred compensation plan providing for a lump sum payment payable on or before the 90th day immediately following the date upon which Employee B separates from service. Employer Y retains the sole discretion to determine when during the 90-day period the payment will be made. Although the plan does not specify a period during one calendar year in which the payment will be made, the plan provides for a payment upon a separation from service in compliance with this section because the period over which the payment may be made is not longer than 90 days.

Example 3. Employee C provides services as an employee of Employer X, but is not a specified employee. Employee C participates in a nonqualified deferred compensation plan providing for a lump sum payment payable on or before the 180th day following the date upon which Employee C separates from service. Employer X retains the sole discretion to determine when during the 180-day period the payment will be made. Because the plan does not specify a period during one calendar year in which the payment will be made, and because the period over which the payment may be made is longer than 90 days, the plan does not provide for a payment upon a separation from service that complies with this section.

Example 4. Employee D provides services as an employee of Employer W, but is not a specified employee. Employee D participates in a nonqualified deferred compensation plan providing for 10 installment payments payable on the first 10 anniversaries of the date Employee D separates from service, provided that no installment payment in any year may be more than 1% of Employer W's net income for the previous calendar year, and provided further that the excess over such limit that would otherwise be payable but is not paid due to application of the limit will become payable as of the first installment payment date at which time such amount, in combination with any installment payment otherwise due Employee D, does not exceed 1% of Employer W's net income for the previous calendar year. Provided that Employee D does not retain effective control of the calculation of Employer W's net income or the amount that Employee D will not be paid due to application of the limit, the plan provides for a schedule of payments upon a separation from service that complies with this section.

Example 5. Employee E and Employee F provide services as employees of Employer V, but neither is a specified employee. Employee E and Employee F both participate in substantially identical nonqualified deferred compensation plans providing for 10 installment payments payable on the first 10 anniversaries of the date the respective employee separates from service, provided that the total amount of installment payments in any year may not be more than 1% of Employer V's net income for the previous year, that where any payments are not made due to application of the limit the determination of the amount not paid to a particular employee will be made by applying the overall limit proportionately based upon the

installment payment due the employee that year, and that the excess over such limit that would otherwise be payable but is not paid due to application of the limit will become payable as of the first installment payment date at which time such amount, in combination with any installment payments otherwise due the participants, does not exceed 1% of Employer V's net income for the previous calendar year. Provided that neither Employee E nor Employee F retains effective control of the calculation of Employer V's net income or the amount that the respective employee will not be paid due to application of the limit, the plan provides for a schedule of payments upon a separation from service that complies with this section.

Example 6. Employee G provides services as an employee of Employer U, but is not a specified employee. As a *bona fide* part of this employment relationship, Employee G provides professional services to clients of Employer U as part of the *bona fide*, ordinary course of Employer U's trade or business. Under an arrangement between Employee G and Employer U, Employer U agrees to pay Employee G upon Employee G's separation from service an amount equal to 5% of any amount collected from Company T, a client of Employer U for which Employee G performed services during his employment with Employer U, during the 36 months following Employee G's separation from service. Under the arrangement, the amounts due to Employee G based upon payments received by Employer U during any calendar year are payable to Employee G on April 1 of the subsequent calendar year. Provided that Employee G does not have effective control of Employer U, Company T, or the collection of any amounts due Employer Y from Company T, the arrangement provides for a schedule of payments upon a separation from service that complies with this section.

Example 7. Employee H provides services as an employee of Employer S, but is not a specified employee. Under a plan sponsored by Employer S, Employee H has a legally binding right upon a separation from service to the reimbursement of country club dues paid in the calendar year of the separation from service and each of the next 3 calendar years following the separation from service in an amount not to exceed \$30,000 in any calendar year, provided that the amount of dues paid in any calendar year that are eligible for reimbursement equals only the amount actually expended during such calendar year, and the maximum amount available for reimbursement in any calendar year will not be increased or decreased to reflect the amount expended or reimbursed in a prior or subsequent calendar year. The plan further provides that any reimbursement must be paid to Employee H by December 31 of the calendar year following the year in which Employee H pays the country club dues. The reimbursement plan provides for a schedule of payments upon a separation from service that complies with this section.

Example 8. Employee J provides services as an employee of Employer Q, but is not a specified employee. Under a plan sponsored by Employer Q, Employee J has a legally binding right upon a separation from service to the reimbursement of country club dues paid during the calendar year in which the separation from service occurs and the next 3 calendar years in a total amount not to exceed \$90,000. The plan further provides that any reimbursement must be paid to Employee J by December 31 of the calendar

year following the year in which Employee J pays the country club dues. Because the reimbursement of a payment of country club dues in one calendar year may affect the amount of country club dues available for reimbursement in another calendar year, the plan does not provide for a schedule of payments upon a separation from service that complies with this section.

(2) *Separation from service—required delay in payment to a specified employee pursuant to a separation from service—(i) In general.* In the case of any service provider who is a specified employee (as defined in §1.409A-1(i)) as of the date of a separation from service, the requirements of paragraph (a)(1) of this section permitting a payment upon a separation from service are satisfied only if payments may not be made before the date that is six months after the date of separation from service (or, if earlier than the end of the six-month period, the date of death of the specified employee). For this purpose, a service provider who is not a specified employee as of the date of a separation from service will not be treated as subject to this requirement even if the service provider would have become a specified employee if the service provider had continued to provide services through the next specified employee effective date. Similarly, a service provider who is treated as a specified employee as of the date of a separation from service will be subject to this requirement even if the service provider would not have been treated as a specified employee after the next specified employee effective date had the specified employee continued providing services through the next specified employee effective date. Notwithstanding the foregoing, this paragraph (i)(2)(i) does not apply to a payment made under the circumstances described in paragraph (j)(4)(ii) (domestic relations order), (j)(4)(iii) (conflicts of interest), or (j)(4)(vi) (payment of employment taxes) of this section.

(ii) *Application of payment rules to delayed payments.* The required delay in payment is met if payments to which a specified employee would otherwise be entitled during the first six months following the date of separation from service are accumulated and paid on the first day of the seventh month following the date of separation from service, or if each payment to which a specified employee is otherwise entitled upon a separation from service is delayed by six months.

A service recipient may retain discretion to choose which method will be implemented, provided that no direct or indirect election as to the method may be provided to the service provider. For an affected specified employee, a date upon which the plan or the service recipient designates that the payment will be made after the six-month delay is treated as a fixed payment date for purposes of paragraph (d) of this section once the separation from service has occurred.

(3) *Unforeseeable emergency—(i) Definition.* For purposes of §§1.409A-1 and 1.409A-2, this section, and §§1.409A-4 through 1.409A-6, an *unforeseeable emergency* is a severe financial hardship to the service provider resulting from an illness or accident of the service provider, the service provider's spouse, the service provider's beneficiary, or the service provider's dependent (as defined in section 152, without regard to section 152(b)(1), (b)(2), and (d)(1)(B)); loss of the service provider's property due to casualty (including the need to rebuild a home following damage to a home not otherwise covered by insurance, for example, not as a result of a natural disaster); or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the service provider. For example, the imminent foreclosure of or eviction from the service provider's primary residence may constitute an unforeseeable emergency. In addition, the need to pay for medical expenses, including non-refundable deductibles, as well as for the costs of prescription drug medication, may constitute an unforeseeable emergency. Finally, the need to pay for the funeral expenses of a spouse, a beneficiary, or a dependent (as defined in section 152, without regard to section 152(b)(1), (b)(2), and (d)(1)(B)) may also constitute an unforeseeable emergency. Except as otherwise provided in this paragraph (i)(3)(i), the purchase of a home and the payment of college tuition are not unforeseeable emergencies. Whether a service provider is faced with an unforeseeable emergency permitting a distribution under this paragraph (i)(3)(i) is to be determined based on the relevant facts and circumstances of each case, but, in any case, a distribution on account of unforeseeable emergency may not be made to the extent that such emergency is or may be relieved

through reimbursement or compensation from insurance or otherwise, by liquidation of the service provider's assets, to the extent the liquidation of such assets would not cause severe financial hardship, or by cessation of deferrals under the plan. A plan may provide for a payment upon a specific type or types of unforeseeable emergency, without providing for payment upon all unforeseeable emergencies, provided that any event upon which a payment may be made qualifies as an unforeseeable emergency.

(ii) *Amount of payment permitted upon an unforeseeable emergency.* Distributions because of an unforeseeable emergency must be limited to the amount reasonably necessary to satisfy the emergency need (which may include amounts necessary to pay any Federal, state, local, or foreign income taxes or penalties reasonably anticipated to result from the distribution). Determinations of amounts reasonably necessary to satisfy the emergency need must take into account any additional compensation that is available if the plan provides for cancellation of a deferral election upon a payment due to an unforeseeable emergency. See paragraph (j)(4)(viii) of this section. However, the determination of amounts reasonably necessary to satisfy the emergency need is not required to take into account any additional compensation that is available from a qualified employer plan as defined in §1.409A-1(a)(2) (including any amount available by obtaining a loan under the plan), or that due to the unforeseeable emergency is available under another nonqualified deferred compensation plan (including a plan that would provide for deferred compensation except due to the application of the effective date provisions under §1.409A-6). The payment may be made from any plan in which the service provider participates that provides for payment upon an unforeseeable emergency, provided that the plan under which the payment was made must be designated at the time of payment.

(iii) *Payments due to an unforeseeable emergency.* A service provider may retain discretion with respect to whether to apply for a payment upon an unforeseeable emergency, and a service recipient may retain discretion with respect to whether to make a payment available under the plan due to an unforeseeable emergency. A ser-

vice provider who has experienced an unforeseeable emergency will not be treated as making a subsequent deferral election under §1.409A-2(b) (subsequent deferral election rules) if the service provider does not apply for or elect to receive a payment available under the plan. A service recipient will not be treated as making a subsequent deferral election under §1.409A-2(b) (subsequent deferral election rules) if the service recipient exercises its discretion not to make a payment otherwise available due to an unforeseeable emergency.

(4) *Disability—(i) In general.* For purposes of §§1.409A-1 and 1.409A-2, this section, and §§1.409A-4 through 1.409A-6, except as otherwise specifically provided, a service provider is considered disabled if the service provider meets one of the following requirements:

(A) The service provider is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than 12 months.

(B) The service provider is, by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the service provider's employer.

(ii) *Limited plan definition of disability.* A plan may provide for a payment upon any disability, and need not provide for a payment upon all disabilities, provided that any disability upon which a payment may be made under the plan complies with the provisions of this paragraph (i)(4).

(iii) *Determination of disability.* A plan may provide that a service provider will be deemed disabled if determined to be totally disabled by the Social Security Administration or Railroad Retirement Board. A plan may also provide that a service provider will be deemed disabled if determined to be disabled in accordance with a disability insurance program, provided that the definition of disability applied under such disability insurance program complies with the requirements of this paragraph (i)(4).

(5) *Change in the ownership or effective control of a corporation, or a change in the ownership of a substantial portion of the assets of a corporation—(i) In general.* Pursuant to section 409A(a)(2)(A)(v), a plan may permit a payment upon the occurrence of a change in the ownership of the corporation (as defined in paragraph (i)(5)(v) of this section), a change in effective control of the corporation (as defined in paragraph (i)(5)(vi) of this section), or a change in the ownership of a substantial portion of the assets of the corporation (as defined in paragraph (i)(5)(vii) of this section) (collectively referred to as a change in control event). To qualify as a change in control event, the occurrence of the event must be objectively determinable and any requirement that any other person or group, such as a plan administrator or compensation committee, certify the occurrence of a change in control event must be strictly ministerial and not involve any discretionary authority. The plan may provide for a payment on a particular type or types of change in control events, and need not provide for a payment on all such events, provided that each event upon which a payment is provided qualifies as a change in control event. For rules regarding the ability of the service recipient to terminate the plan and pay amounts of deferred compensation upon a change in control event, see paragraph (j)(4)(ix)(B) of this section.

(ii) *Identification of relevant corporation—(A) In general.* To constitute a change in control event with respect to the service provider, the change in control event must relate to—

(1) The corporation for whom the service provider is performing services at the time of the change in control event;

(2) The corporation that is liable for the payment of the deferred compensation (or all corporations liable for the payment if more than one corporation is liable) but only if either the deferred compensation is attributable to the performance of service by the service provider for such corporation (or corporations) or there is a *bona fide* business purpose for such corporation or corporations to be liable for such payment and, in either case, no significant purpose of making such corporation or corporations liable for such payment is the avoidance of Federal income tax; or

(3) A corporation that is a majority shareholder of a corporation identified in paragraph (i)(5)(ii)(A)(I) or (2) of this section, or any corporation in a chain of corporations in which each corporation is a majority shareholder of another corporation in the chain, ending in a corporation identified in paragraph (i)(5)(ii)(A)(I) or (2) of this section.

(B) *Majority shareholder.* For purposes of this paragraph (i)(5)(ii), a majority shareholder is a shareholder owning more than 50 percent of the total fair market value and total voting power of such corporation.

(C) *Example.* The following example illustrates the rules of this paragraph (i)(5)(ii):

Example. Corporation A is a majority shareholder of Corporation B, which is a majority shareholder of Corporation C. A change in ownership of Corporation B constitutes a change in control event to service providers performing services for Corporation B or Corporation C, and to service providers for which Corporation B or Corporation C is solely liable for payments under the plan (for example, former employees), but is not a change in control event as to Corporation A or any other corporation of which Corporation A is a majority shareholder unless the sale constitutes a change in the ownership of a substantial portion of Corporation A's assets (see paragraph (i)(5)(vii) of this section).

(iii) *Attribution of stock ownership.* For purposes of paragraph (i)(5) of this section, section 318(a) applies to determine stock ownership. Stock underlying a vested option is considered owned by the individual who holds the vested option (and the stock underlying an unvested option is not considered owned by the individual who holds the unvested option). For purposes of the preceding sentence, however, if a vested option is exercisable for stock that is not substantially vested (as defined by §1.83-3(b) and (j)), the stock underlying the option is not treated as owned by the individual who holds the option.

(iv) *Special rules for certain delayed payments pursuant to a change in control event—(A) Certain transaction-based compensation.* Payments of compensation related to a change in control event described in paragraph (i)(5)(v) of this section (change in the ownership of a corporation) or paragraph (i)(5)(vii) of this section (change in the ownership of a substantial portion of a corporation's assets), that occur because a service recipient purchases its stock held by the service provider or because the service recipient

or a third party purchases a stock right held by a service provider, or that are calculated by reference to the value of stock of the service recipient (collectively, transaction-based compensation), may be treated as paid at a designated date or pursuant to a payment schedule that complies with the requirements of section 409A if the transaction-based compensation is paid on the same schedule and under the same terms and conditions as apply to payments to shareholders generally with respect to stock of the service recipient pursuant to a change in control event described in paragraph (i)(5)(v) of this section (change in the ownership of a corporation) or as apply to payments to the service recipient pursuant to a change in control event described in paragraph (i)(5)(vii) of this section (change in the ownership of a substantial portion of a corporation's assets), and to the extent that the transaction-based compensation is paid not later than five years after the change in control event, the payment of such compensation will not violate the initial or subsequent deferral election rules set out in §1.409A-2(a) and (b) solely as a result of such transaction-based compensation being paid pursuant to such schedule and terms and conditions. If before and in connection with a change in control event described in paragraph (i)(5)(v) or (i)(5)(vii) of this section, transaction-based compensation that would otherwise be payable as a result of such event is made subject to a condition on payment that constitutes a substantial risk of forfeiture (as defined in §1.409A-1(d), without regard to the provisions of that section under which additions or extensions of forfeiture conditions are disregarded) and the transaction-based compensation is payable under the same terms and conditions as apply to payments made to shareholders generally with respect to stock of the service recipient pursuant to a change in control event described in paragraph (i)(5)(v) of this section or to payments to the service recipient pursuant to a change in control event described in paragraph (i)(5)(vii) of this section, for purposes of determining whether such transaction-based compensation is a short-term deferral the requirements of §1.409A-1(b)(4) are applied as if the legally binding right to such transaction-based compensation arose on

the date that it became subject to such substantial risk of forfeiture.

(B) *Certain nonvested compensation.* Notwithstanding the provisions of §1.409A-1(d) (definition of a substantial risk of forfeiture) that disregard the extension or modification of a condition for purposes of determining whether a condition on payment constitutes a substantial risk of forfeiture, a condition that is a substantial risk of forfeiture that otherwise would lapse as a result of a change in control event described in paragraph (i)(5)(v) or (i)(5)(vii) of this section may be extended or modified before and in connection with such event to provide for a condition on payment that will not lapse as a result of such change in control event, and such extended or modified condition will be treated as continuing to subject the amount to a substantial risk of forfeiture, provided that the transaction constituting the change in control event is a *bona fide* arm's length transaction between the service recipient or its shareholders and one or more parties who are unrelated to the service recipient and service provider (applying the rules of §1.409A-1(f)(2)(ii)) and the modified or extended condition to which the payment is subject would otherwise be treated as a substantial risk of forfeiture under §1.409A-1(d) (without regard to the provisions disregarding additions or extensions of forfeiture conditions). In such a case, the continued application of a fixed schedule of payments based upon the lapse of the substantial risk of forfeiture, so that payments commence upon the lapse of the modified or extended condition on payment, will not be treated as a change in the fixed schedule of payments for purposes of §1.409A-2(b) (subsequent deferral elections) or paragraph (j) of this section (prohibition on the acceleration of payments).

(v) *Change in the ownership of a corporation—(A) In general.* Except as provided in paragraph (i)(5)(vi)(C) of this section, a change in the ownership of a corporation occurs on the date that any one person, or more than one person acting as a group (as defined in paragraph (i)(5)(v)(B) of this section), acquires ownership of stock of the corporation that, together with stock held by such person or group, constitutes more than 50 percent of the total fair market value or total voting

power of the stock of such corporation. A nonqualified deferred compensation plan may provide that amounts payable upon a change in the ownership of a corporation will be paid only if the conditions in the preceding sentence are satisfied but substituting a percentage specified in the plan that is higher than 50 percent for the words “50 percent” in the preceding sentence, but only if the provision is set forth in the plan no later than the date by which the time and form of payment must be established under §1.409A-2. However, if any one person, or more than one person acting as a group, is considered to own more than 50 percent of the total fair market value or total voting power of the stock of a corporation (or such higher percentage specified in accordance with the preceding sentence), the acquisition of additional stock by the same person or persons is not considered to cause a change in the ownership of the corporation (or to cause a change in the effective control of the corporation (within the meaning of paragraph (i)(5)(vi) of this section)). An increase in the percentage of stock owned by any one person, or persons acting as a group, as a result of a transaction in which the corporation acquires its stock in exchange for property will be treated as an acquisition of stock for purposes of this section. This section applies only when there is a transfer of stock of a corporation (or issuance of stock of a corporation) and stock in such corporation remains outstanding after the transaction (see paragraph (i)(5)(vii) of this section for rules regarding the transfer of assets of a corporation). See §1.280G-1, Q&A-27(d), *Example 1*, *Example 2*, *Example 5*, and *Example 6*.

(B) *Persons acting as a group.* For purposes of paragraph (i)(5)(v)(A) of this section, persons will not be considered to be acting as a group solely because they purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is

considered to be acting as a group with other shareholders only with respect to the ownership in that corporation before the transaction giving rise to the change and not with respect to the ownership interest in the other corporation. See §1.280G-1, Q&A-27(d), *Example 3* and *Example 4*.

(vi) *Change in the effective control of a corporation—(A) In general.* Notwithstanding that a corporation has not undergone a change in ownership under paragraph (i)(5)(v) of this section, a change in the effective control of the corporation occurs only on either of the following dates:

(1) The date any one person, or more than one person acting as a group (as determined under paragraph (i)(5)(v)(B) of this section), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) ownership of stock of the corporation possessing 30 percent or more of the total voting power of the stock of such corporation. A nonqualified deferred compensation plan may provide that amounts payable upon an effective change in control of a corporation will be paid only if the conditions in the preceding sentence are satisfied but substituting a percentage specified in the plan that is higher than 30 percent for the word “30 percent” in the preceding sentence, but only if the percentage is set forth in the plan no later than the date by which the time and form of payment must be established under §1.409A-2).

(2) The date a majority of members of the corporation’s board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation’s board of directors before the date of the appointment or election, provided that for purposes of this paragraph (i)(5)(vi)(A) the term *corporation* refers solely to the relevant corporation identified in paragraph (i)(5)(ii) of this section for which no other corporation is a majority shareholder for purposes of that paragraph. For example, if Corporation A is a publicly held corporation with no majority shareholder, and Corporation A is the majority shareholder of Corporation B, which is the majority shareholder of Corporation C, the term *corporation* for purposes of this paragraph (i)(5)(vi)(A)(2) would refer solely to Corporation A. A nonqualified deferred compensation plan

may provide that amounts payable upon a change in the effective control of a corporation will be paid only if the conditions in the first sentence of this paragraph are satisfied substituting a portion of the members of the corporation’s board of directors that is higher than the words “a majority of the members of the corporation’s board of directors” in the first sentence of this paragraph, but only if the higher portion is set forth in the plan no later than the date by which the time and form of payment must be established under §1.409A-2(a).

(B) *Multiple change in control events.* A change in effective control may occur in a transaction in which one of the two corporations involved in the transaction has a change in control event under paragraph (i)(5)(v) or (i)(5)(vii) of this section. Thus, for example, assume Corporation P transfers more than 40 percent of the total gross fair market value of its assets to Corporation O in exchange for 35 percent of O’s stock. P has undergone a change in ownership of a substantial portion of its assets under paragraph (i)(5)(vii) of this section and O has a change in effective control under this paragraph (i)(5)(vi).

(C) *Acquisition of additional control.* If any one person, or more than one person acting as a group, is considered to effectively control a corporation (within the meaning of this paragraph (i)(5)(vi)), the acquisition of additional control of the corporation by the same person or persons is not considered to cause a change in the effective control of the corporation (or to cause a change in the ownership of the corporation within the meaning of paragraph (i)(5)(v) of this section).

(D) *Persons acting as a group.* Persons will not be considered to be acting as a group solely because they purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only with respect to the ownership in that cor-

poration before the transaction giving rise to the change and not with respect to the ownership interest in the other corporation. See §1.280G-1, Q&A-27(d), *Example 4*.

(vii) *Change in the ownership of a substantial portion of a corporation's assets—(A) In general.* A change in the ownership of a substantial portion of a corporation's assets occurs on the date that any one person, or more than one person acting as a group (as determined in paragraph (i)(5)(v)(B) of this section), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) assets from the corporation that have a total gross fair market value equal to or more than 40 percent of the total gross fair market value of all of the assets of the corporation immediately before such acquisition or acquisitions (or such higher amount specified by the plan no later than the date by which the time and form of payment must be established under §1.409A-2). For this purpose, gross fair market value means the value of the assets of the corporation, or the value of the assets being disposed of, determined without regard to any liabilities associated with such assets.

(B) *Transfers to a related person—(1)* There is no change in control event under this paragraph (i)(5)(vii) when there is a transfer to an entity that is controlled by the shareholders of the transferring corporation immediately after the transfer, as provided in this paragraph (i)(5)(vii)(B). A transfer of assets by a corporation is not treated as a change in the ownership of such assets if the assets are transferred to—

(i) A shareholder of the corporation (immediately before the asset transfer) in exchange for or with respect to its stock;

(ii) An entity, 50 percent or more of the total value or voting power of which is owned, directly or indirectly, by the corporation;

(iii) A person, or more than one person acting as a group, that owns, directly or indirectly, 50 percent or more of the total value or voting power of all the outstanding stock of the corporation; or

(iv) An entity, at least 50 percent of the total value or voting power of which is owned, directly or indirectly, by a person described in paragraph (i)(5)(vii)(B)(I)(iii) of this section.

(2) For purposes of this paragraph (i)(5)(vii)(B) and except as otherwise provided in this paragraph (i), a person's status is determined immediately after the transfer of the assets. For example, a transfer to a corporation in which the transferor corporation has no ownership interest before the transaction, but that is a majority-owned subsidiary of the transferor corporation after the transaction is not treated as a change in the ownership of the assets of the transferor corporation.

(C) *Persons acting as a group.* Persons will not be considered to be acting as a group solely because they purchase assets of the same corporation at the same time. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of assets, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of assets, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only to the extent of the ownership in that corporation before the transaction giving rise to the change and not with respect to the ownership interest in the other corporation. See §1.280G-1, Q&A-27(d), *Example 4*.

(6) *Certain back-to-back arrangements—(i) In general.* This paragraph (i)(6) applies where a service provider is providing services to a service recipient (the intermediate service recipient), who in turn is providing services to another service recipient (the ultimate service recipient), the services provided by the service provider to the intermediate service recipient are closely related to the services provided by the intermediate service recipient to the ultimate service recipient, there is a nonqualified deferred compensation plan providing for payments by the ultimate service recipient to the intermediate service recipient (the ultimate service recipient plan), there is a nonqualified deferred compensation plan or other agreement, method, program, or other arrangement providing for payments of compensation by the intermediate service recipient to the service provider (the intermediate service recipient plan), and the intermediate service recipient plan provides for a payment upon the occurrence

of an event described in paragraph (a)(1), (2), (3), (5), or (6) of this section. In such a case, notwithstanding the generally applicable limits on payments in paragraph (a) of this section, the ultimate service recipient plan may provide for a payment to the intermediate service recipient upon the occurrence of a payment event under the intermediate service recipient plan described in paragraph (a)(1), (2), (3), (5), or (6) of this section if the time and form of payment is defined as the same time and form of payment provided under the intermediate service recipient plan, the amount of the payment under the ultimate service recipient plan does not exceed the amount of the payment under the intermediate service recipient plan, and the ultimate service recipient plan and the intermediate service recipient plan otherwise satisfy the requirements of section 409A (regardless of whether such plan is subject to section 409A).

(ii) *Example.* The provisions of paragraph (i)(6)(i) of this section are illustrated by the following example:

Example. Company B (intermediate service recipient) provides services to Company C (ultimate service recipient). Employee A (service provider) provides services to Company B that are closely related to the services Company B provides to Company C. Pursuant to a nonqualified deferred compensation plan meeting the requirements of section 409A, Employee A is entitled to a payment of deferred compensation upon a separation from service with Company B (the intermediate service recipient plan). Under an arrangement between Company B and Company C (the ultimate service recipient plan), Company C agrees to pay an amount of deferred compensation to Company B upon Employee A's separation from service with Company B, in accordance with the time, form and amount of payment provided in the intermediate service recipient plan. Provided that the intermediate service recipient plan and the ultimate service recipient plan otherwise comply with the requirements of section 409A (regardless of whether such arrangements are subject to section 409A), Company C's payment to Company B of the amount due under the ultimate service recipient plan upon the separation from service of Employee A from Company B may constitute a permissible payment event for purposes of paragraph (a) of this section.

(j) *Prohibition on acceleration of payments—(1) In general.* Except as provided in paragraph (j)(4) of this section, a nonqualified deferred compensation plan may not permit the acceleration of the time or schedule of any payment or amount scheduled to be paid pursuant to the terms of the plan, and no such accelerated payment may be made whether or not provided for

under the terms of such plan. For purposes of determining whether a payment of deferred compensation has been made, the rules of paragraph (f) of this section (substituted payments) apply. For purposes of this paragraph (j), an impermissible acceleration does not occur if payment is made in accordance with plan provisions or an election as to the time and form of payment in effect at the time of initial deferral (or added in accordance with the rules applicable to subsequent deferral elections under §1.409A-2(b)) pursuant to which payment is required to be made on an accelerated schedule as a result of an intervening event that is an event described in paragraph (a)(1), (2), (3), (5), or (6) of this section. For example, a plan may provide that a participant will receive six installment payments commencing at separation from service, and also provide that if the participant dies after such payments commence but before all payments have been made, all remaining amounts will be paid in a lump sum payment. Additionally, it is not an acceleration of the time or schedule of payment of a deferral of compensation if a service recipient waives or accelerates the satisfaction of a condition constituting a substantial risk of forfeiture applicable to such deferral of compensation, provided that the requirements of section 409A (including the requirement that the payment be made upon a permissible payment event) are otherwise satisfied with respect to such deferral of compensation. For example, if a nonqualified deferred compensation plan provides for a lump sum payment of the vested benefit upon separation from service, and the benefit vests under the plan only after 10 years of service, it is not a violation of the requirements of section 409A if the service recipient reduces the vesting requirement to five years of service, even if a service provider becomes vested as a result and receives a payment in connection with a separation from service before the service provider would have completed 10 years of service. However, if the plan in this example had provided for a payment at a fixed date, rather than at separation from service, the date of payment could not be accelerated due to the accelerated vesting. For the definition of a payment for purposes of this paragraph (j), see §1.409A-2(b)(5) (coordination of the subsequent deferral election rules with

the prohibition on acceleration of payments). For other permissible payments, see §1.409A-2(b)(2)(iii) (certain immediate payments of remaining installments) and paragraph (d) of this section (certain payments made no more than 30 days before the designated payment date).

(2) *Application to multiple payment events.* Generally, the addition of a permissible payment event, the deletion of a permissible payment event, or the substitution of one permissible payment event for another permissible payment event, results in an acceleration of a payment if the addition, deletion, or substitution could result in the payment being made at an earlier date than such payment would have been made absent such addition, deletion, or substitution. Notwithstanding the previous sentence, the addition of death, disability (as defined in paragraph (i)(4) of this section), or an unforeseeable emergency (as defined in paragraph (i)(3) of this section), as a potentially earlier alternative payment event to an amount previously deferred will not be treated as resulting in an acceleration of a payment, even if such addition results in the payment being paid at an earlier time than such payment would have been made absent the addition of the payment event. However, the addition of such a payment event as a potentially later alternative payment event generally is subject to the rules governing changes in the time and form of payment (see §1.409A-2(b)).

(3) *Beneficiaries.* The rules of this paragraph (j) apply to elections by beneficiaries with respect to the time and form of payment, as well as elections by service providers or service recipients with respect to the time and form of payment to beneficiaries. An election to change the identity of a beneficiary does not constitute an acceleration of a payment merely because the election changes the identity of the recipient of the payment, if the time and form of the payment is not otherwise changed. In addition, an election before the commencement of a life annuity to change the identity of a beneficiary does not constitute an acceleration of a payment if the change in the time of payments stems solely from the different life expectancy of the new beneficiary, such as in the case of a joint and survivor annuity, and does not change the commencement date of the life annuity.

(4) *Exceptions—(i) In general.* Except as otherwise expressly provided, a plan may provide for the acceleration of a payment in accordance with paragraphs (j)(4)(ii) through (xiv) of this section, or may provide a service recipient discretion to accelerate payments in accordance with the provisions of paragraphs (j)(4)(ii) through (xiv) of this section. A plan may not provide a service provider discretion with respect to whether a payment will be accelerated, and a service recipient may not provide a service provider a direct or indirect election as to whether the service recipient's discretion to accelerate a payment will be exercised, even if such acceleration would be permitted under paragraphs (j)(4)(ii) through (xiv) of this section. Whether a service recipient has provided a service provider an election as to whether the service recipient's discretion to accelerate a payment will be exercised is determined based on all the facts and circumstances, including whether similarly situated service providers have been treated differently. Except as otherwise provided in paragraphs (j)(4)(ii) through (xiv) of this section, the plan need not set forth the exception in writing, and provided all other requirements of this section are met, the making of such a payment or the addition of a plan term permitting the making of such a payment will not constitute the acceleration of a payment, and the failure to make such a payment or the deletion or modification of a plan term permitting the making of such a payment will not be subject to the rules regarding a change in the time and form of payment under §1.409A-2(b).

(ii) *Domestic relations order.* A plan may provide for acceleration of the time or schedule of a payment under the plan to an individual other than the service provider, or a payment under such plan may be made to an individual other than the service provider, to the extent necessary to fulfill a domestic relations order (as defined in section 414(p)(1)(B)).

(iii) *Conflicts of interest—(A) Compliance with ethics agreements with the Federal government.* A plan may provide for acceleration of the time or schedule of a payment under the plan, or a payment may be made under a plan, to the extent necessary for any Federal officer or employee in the executive branch to comply with an

ethics agreement with the Federal government.

(B) *Compliance with ethics laws or conflicts of interest laws.* A plan may provide for acceleration of the time or schedule of a payment under the plan, or a payment may be made under a plan, to the extent reasonably necessary to avoid the violation of an applicable Federal, state, local, or foreign ethics law or conflicts of interest law (including where such payment is reasonably necessary to permit the service provider to participate in activities in the normal course of his or her position in which the service provider would otherwise not be able to participate under an applicable rule). A payment is reasonably necessary to avoid the violation of a Federal, state, local, or foreign ethics law or conflicts of interest law if the payment is a necessary part of a course of action that results in compliance with a Federal, state, local, or foreign ethics law or conflicts of interest law that would be violated absent such course of action, regardless of whether other actions would also result in compliance with the Federal, state, local, or foreign ethics law or conflicts of interest law. For this purpose, a provision of foreign law is considered applicable only to foreign earned income (as defined under section 911(b)(1) without regard to section 911(b)(1)(B)(iv) and without regard to the requirement that the income be attributable to services performed during the period described in section 911(d)(1)(A) or (B)) from sources within the foreign country that promulgated such law.

(iv) *Section 457 plans.* A plan subject to section 457(f) may provide for an acceleration of the time or schedule of a payment to a service provider, or a payment may be made under such a plan, to pay Federal, state, local, and foreign income taxes due upon a vesting event, provided that the amount of such payment is not more than an amount equal to the Federal, state, local, and foreign income tax withholding that would have been remitted by the employer if there had been a payment of wages equal to the income includible by the service provider under section 457(f) at the time of the vesting.

(v) *Limited cashouts.* A plan may require or provide a service recipient discretion to require (or be amended to require or to provide a service recipient discretion to require), a mandatory lump sum payment

of amounts deferred under the plan that do not exceed a specified amount, provided that such plan term or amendment is executed and effective, and any required exercise of service recipient discretion is evidenced in writing, no later than the date of such payment, and provided that—

(A) The payment results in the termination and liquidation of the entirety of the service provider's interest under the plan, including all agreements, methods, programs, or other arrangements with respect to which deferrals of compensation are treated as having been deferred under a single nonqualified deferred compensation plan under §1.409A-1(c)(2); and

(B) The payment is not greater than the applicable dollar amount under section 402(g)(1)(B).

(vi) *Payment of employment taxes.* A plan may provide for the acceleration of the time or schedule of a payment, or a payment may be made under the plan, to pay the Federal Insurance Contributions Act (FICA) tax imposed under section 3101, section 3121(a), and section 3121(v)(2), or the Railroad Retirement Act tax imposed under section 3201, section 3211, section 3231(e)(1), and section 3231(e)(8), where applicable, on compensation deferred under the plan (the FICA or RRTA amount). Additionally, a plan may provide for the acceleration of the time or schedule of a payment, or a payment may be made under the plan, to pay the income tax at source on wages imposed under section 3401 or the corresponding withholding provisions of applicable state, local, or foreign tax laws as a result of the payment of the FICA or RRTA amount, and to pay the additional income tax at source on wages attributable to the pyramiding section 3401 wages and taxes. However, the total payment under this acceleration provision must not exceed the aggregate of the FICA or RRTA amount, and the income tax withholding related to such FICA or RRTA amount.

(vii) *Payment upon income inclusion under section 409A.* A plan may provide for the acceleration of the time or schedule of a payment, or a payment under such plan may be made, at any time the plan fails to meet the requirements of section 409A and these regulations. Such payment may not exceed the amount required to be included in income as a result of the failure to comply with the requirements of section 409A and these regulations.

(viii) *Cancellation of deferrals following an unforeseeable emergency or hardship distribution.* A plan may provide for a cancellation of a service provider's deferral election, or such a cancellation may be made, due to an unforeseeable emergency or a hardship distribution pursuant to §1.401(k)-1(d)(3). The deferral election must be cancelled, not merely postponed or otherwise delayed. Accordingly, any later deferral election will be subject to the provisions governing initial deferral elections. See §1.409A-2(a).

(ix) *Plan terminations and liquidations.* A plan may provide for the acceleration of the time and form of a payment, or a payment under such plan may be made, where the acceleration of the payment is made pursuant to a termination and liquidation of the plan in accordance with one of the following:

(A) The service recipient's termination and liquidation of the plan within 12 months of a corporate dissolution taxed under section 331, or with the approval of a bankruptcy court pursuant to 11 U.S.C. §503(b)(1)(A), provided that the amounts deferred under the plan are included in the participants' gross incomes in the latest of the following years (or, if earlier, the taxable year in which the amount is actually or constructively received).

(1) The calendar year in which the plan termination and liquidation occurs.

(2) The first calendar year in which the amount is no longer subject to a substantial risk of forfeiture.

(3) The first calendar year in which the payment is administratively practicable.

(B) The service recipient's termination and liquidation of the plan pursuant to irrevocable action taken by the service recipient within the 30 days preceding or the 12 months following a change in control event (as defined in paragraph (i)(5) of this section), provided that this paragraph will only apply to a payment under a plan if all agreements, methods, programs, and other arrangements sponsored by the service recipient immediately after the time of the change in control event with respect to which deferrals of compensation are treated as having been deferred under a single plan under §1.409A-1(c)(2) are terminated and liquidated with respect to each participant that experienced the change in control event, so that under the terms of the termination and liquidation

tion all such participants are required to receive all amounts of compensation deferred under the terminated agreements, methods, programs, and other arrangements within 12 months of the date the service recipient irrevocably takes all necessary action to terminate and liquidate the agreements, methods, programs, and other arrangements. Solely for purposes of this paragraph (j)(4)(ix)(B), where the change in control event results from an asset purchase transaction, the applicable service recipient with the discretion to liquidate and terminate the agreements, methods, programs, and other arrangements is the service recipient that is primarily liable immediately after the transaction for the payment of the deferred compensation.

(C) The service recipient's termination and liquidation of the plan, provided that—

(1) The termination and liquidation does not occur proximate to a downturn in the financial health of the service recipient;

(2) The service recipient terminates and liquidates all agreements, methods, programs, and other arrangements sponsored by the service recipient that would be aggregated with any terminated and liquidated agreements, methods, programs, and other arrangements under §1.409A-1(c) if the same service provider had deferrals of compensation under all of the agreements, methods, programs, and other arrangements that are terminated and liquidated;

(3) No payments in liquidation of the plan are made within 12 months of the date the service recipient takes all necessary action to irrevocably terminate and liquidate the plan other than payments that would be payable under the terms of the plan if the action to terminate and liquidate the plan had not occurred;

(4) All payments are made within 24 months of the date the service recipient takes all necessary action to irrevocably terminate and liquidate the plan; and

(5) The service recipient does not adopt a new plan that would be aggregated with any terminated and liquidated plan under §1.409A-1(c) if the same service provider participated in both plans, at any time within three years following the date the service recipient takes all necessary action to irrevocably terminate and liquidate the plan.

(D) Such other events and conditions as the Commissioner may prescribe in generally applicable guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(x) *Certain distributions to avoid a non-allocation year under section 409(p)*. A plan may provide for an acceleration of the time and form of a payment, or a payment may be made under such plan, to prevent the occurrence of a nonallocation year (within the meaning of section 409(p)(3)) in the plan year of an employee stock ownership plan next following the plan year in which such payment is made, provided that the amount distributed may not exceed 125 percent of the minimum amount of distribution necessary to avoid the occurrence of a nonallocation year. Solely for purposes of determining permissible distributions under this paragraph (j)(4)(x), synthetic equity (within the meaning of section 409(p)(6)(C) and §1.409(p)-1(f)) granted during the plan year of the employee stock ownership plan in which such payment is made is disregarded for purposes of determining whether the subsequent plan year would result in a nonallocation year.

(xi) *Payment of state, local, or foreign taxes*. A plan may provide for an acceleration of the time and form of a payment, or a payment may be made under such plan, to reflect payment of state, local, or foreign tax obligations arising from participation in the plan that apply to an amount deferred under the plan before the amount is paid or made available to the participant (the state, local, or foreign tax amount). Such payment may not exceed the amount of such taxes due as a result of participation in the plan. Such payment may be made by distributions to the participant in the form of withholding pursuant to provisions of applicable state, local, or foreign law or by distribution directly to the participant. Additionally, an arrangement may provide for the acceleration of the time or schedule of payment, or a payment may be made under such arrangement, to pay the income tax at source on wages imposed under section 3401 as a result of such payment and to pay the additional income tax at source on wages imposed under section 3401 attributable to such additional section 3401 wages and taxes. However, the total payment under this acceleration provision must not exceed the aggregate of the state,

local, and foreign tax amount, and the income tax withholding related to such state, local, and foreign tax amount.

(xii) *Cancellation of deferral elections due to disability*. A plan may provide for a cancellation of a service provider's deferral election, or a cancellation of such election may be made, where such cancellation occurs by the later of the end of the taxable year of the service provider or the 15th day of the third month following the date the service provider incurs a disability. For purposes of this paragraph, a disability refers to any medically determinable physical or mental impairment resulting in the service provider's inability to perform the duties of his or her position or any substantially similar position, where such impairment can be expected to result in death or can be expected to last for a continuous period of not less than six months.

(xiii) *Certain offsets*. A plan may provide for the acceleration of the time or schedule of a payment, or a payment may be made under such plan, as satisfaction of a debt of the service provider to the service recipient, where such debt is incurred in the ordinary course of the service relationship between the service recipient and the service provider, the entire amount of reduction in any of the service recipient's taxable years does not exceed \$5,000, and the reduction is made at the same time and in the same amount as the debt otherwise would have been due and collected from the service provider.

(xiv) *Bona fide disputes as to a right to a payment*. A plan may provide for the acceleration of the time or schedule of one or more payments, or a payment may be made under such plan, where such payments occur as part of a settlement between the service provider and the service recipient of an arm's length, *bona fide* dispute as to the service provider's right to the deferred amount. Discretion to accelerate payments, other than due to an arm's length settlement of a *bona fide* dispute as to the service provider's right to the deferred amount, is not permitted under this paragraph (j)(4)(xiv). Whether a payment qualifies for the exception under this paragraph is based on all relevant facts and circumstances. A payment will be presumed not to meet this exception unless the payment is subject to a substantial reduction in the value of the payment made in rela-

tion to the amount that would have been payable had there been no dispute as to the service provider's right to the payment. For this purpose, a reduction that is less than 25 percent of the present value of the deferred amount in dispute generally is not a substantial reduction. In addition, a payment will be presumed not to meet this exception if the payment is made proximate to a downturn in the financial health of the service recipient.

(5) *Nonqualified deferred compensation plans linked to qualified employer plans or certain other arrangements.* If a nonqualified deferred compensation plan provides that the amount deferred under the plan is the amount determined under the formula determining benefits under a qualified employer plan (as defined in §1.409A-1(a)(2)), or a broad-based foreign retirement plan (as defined in §1.409A-1(a)(3)(v)) maintained by the service recipient but applied without regard to one or more limitations applicable to the qualified employer plan under the Internal Revenue Code or to the broad-based foreign retirement plan under other applicable law, or that the amount deferred under the nonqualified deferred compensation plan is determined as an amount offset by some or all of the benefits provided under the qualified employer plan or broad-based foreign retirement plan, a decrease in amounts deferred under the nonqualified deferred compensation plan that results directly from changes in benefit limitations applicable to the qualified employer plan or the broad-based foreign retirement plan under the Internal Revenue Code or other applicable law does not constitute an acceleration of a payment under the nonqualified deferred compensation plan, provided that such operation does not otherwise result in a change in the time or form of a payment under the nonqualified deferred compensation plan, and provided further that the change in the amounts deferred under the nonqualified deferred compensation plan does not exceed such change in the amounts deferred under the qualified employer plan or the broad-based foreign retirement plan, as applicable. In addition, with respect to such a nonqualified deferred compensation plan, the following actions or failures to act will not constitute an acceleration of a payment under the nonqualified deferred compensation plan

even if in accordance with the terms of the nonqualified deferred compensation plan, the actions or inactions result in a decrease in the amounts deferred under the plan, provided that such actions or inactions do not otherwise affect the time or form of payment under the nonqualified deferred compensation plan, and provided further that with respect to actions or inactions described in paragraphs (j)(5)(i) and (ii) of this section, the change in the amount deferred under the nonqualified deferred compensation plan does not exceed the change in the amounts deferred under the qualified employer plan or the broad-based foreign retirement plan, as applicable:

(i) A service provider's action or inaction under the qualified employer plan or broad-based foreign retirement plan with respect to whether to elect to receive a subsidized benefit or an ancillary benefit under the qualified employer plan or broad-based foreign retirement plan.

(ii) The amendment of a qualified employer plan or broad-based foreign retirement plan to increase benefits provided under such plan, or to add or remove a subsidized benefit or an ancillary benefit.

(iii) A service provider's action or inaction under a qualified employer plan with respect to elective deferrals and other employee pre-tax contributions subject to the contribution restrictions under section 401(a)(30) or section 402(g), including an adjustment to a deferral election under such qualified employer plan, provided that for any given taxable year, the service provider's action or inaction does not result in a decrease in the amounts deferred under all nonqualified deferred compensation plans in which the service provider participates (other than amounts described in paragraph (j)(5)(iv) of this section) in excess of the limit with respect to elective deferrals under section 402(g)(1)(A), (B), and (C) in effect for the taxable year in which such action or inaction occurs.

(iv) A service provider's action or inaction under a qualified employer plan with respect to elective deferrals and other employee pre-tax contributions subject to the contributions restrictions under section 401(a)(30) or section 402(g), and after-tax contributions by the service provider to a qualified employer plan that provides for such contributions, that affects the amounts that are credited under one or more nonqualified deferred compensation

plans as matching amounts or other similar amounts contingent on such elective deferrals, pre-tax contributions, or after-tax contributions, provided that the total of such matching or contingent amounts, as applicable, never exceeds 100 percent of the matching or contingent amounts that would be provided under the qualified employer plan absent any plan-based restrictions that reflect limits on qualified plan contributions under the Internal Revenue Code.

(6) *Changes in elections under a cafeteria plan.* A change in an election under a cafeteria plan (as defined in section 125(d)) does not result in an accelerated payment of an amount deferred under a nonqualified deferred compensation plan to the extent that the change in the amount deferred under the nonqualified deferred compensation plan results solely from the application of the change in amount eligible to be treated as compensation under the terms of the nonqualified deferred compensation plan resulting from the election change under the cafeteria plan, to a benefit formula under the nonqualified deferred compensation plan based upon the service provider's eligible compensation, and only to the extent that such change applies in the same manner as any other increase or decrease in compensation would apply to such benefit formula.

§1.409A-4 Calculation of income inclusion. [Reserved].

§1.409A-5 Funding. [Reserved].

§1.409A-6 Application of section 409A and effective dates.

(a) *Statutory application and effective dates—(1) Application to amounts deferred—(i) In general.* Except as otherwise provided in this section, section 409A applies with respect to amounts deferred in taxable years beginning after December 31, 2004, and with respect to amounts deferred in taxable years beginning before January 1, 2005, if the plan under which the deferral is made is materially modified after October 3, 2004. For amounts deferred in taxable years beginning before January 1, 2005, under a plan that is materially modified after October 3, 2004, whether the plan complies with the requirements of section 409A and these regulations is determined by reference to

the terms of the plan in effect as of, and any actions taken under the plan on or after, the date of the material modification. Section 409A is applicable with respect to earnings on amounts deferred only to the extent that section 409A is applicable with respect to the amounts deferred. Accordingly, section 409A does not apply with respect to earnings on amounts deferred before January 1, 2005, unless section 409A applies with respect to the amounts deferred. For this purpose, a right to earnings that is subject to a substantial risk of forfeiture (as defined in §1.83-3(c)) or a requirement to perform further services, on an amount deferred that is not subject to a substantial risk of forfeiture (as defined in §1.83-3(c)) or a requirement to perform further services, is not treated as earnings on the amount deferred, but a separate right to compensation. Except as otherwise provided in applicable guidance (see §601.601(d)(2) of this chapter), the provisions of §§1.409A-1 through 1.409A-5 and this section provide the exclusive means of identifying agreements, methods, programs, or other arrangements subject to section 409A, and the exclusive means of satisfying the requirements of section 409A with respect to such agreements, methods, programs, or other arrangements.

(ii) *Collectively bargained plans.* Section 409A does not apply with respect to amounts deferred under a plan maintained pursuant to one or more *bona fide* collective bargaining agreements in effect on October 3, 2004, for the period ending on the earlier of the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after October 3, 2004) or December 31, 2009.

(2) *Identification of date of deferral for statutory effective date purposes.* For purposes of determining whether section 409A is applicable with respect to an amount, the amount is considered deferred before January 1, 2005, if before January 1, 2005, the service provider had a legally binding right to be paid the amount, and the right to the amount was earned and vested. For purposes of this paragraph (a)(2), a right to an amount was earned and vested only if the amount was not subject to a substantial risk of forfeiture (as defined in §1.83-3(c)) or a requirement to perform further services.

Amounts to which the service provider did not have a legally binding right before January 1, 2005 (for example because the service recipient retained discretion to reduce the amount), will not be considered deferred before January 1, 2005. In addition, amounts to which the service provider had a legally binding right before January 1, 2005, but the right to which was subject to a substantial risk of forfeiture or a requirement to perform further services after December 31, 2004, are not considered deferred before January 1, 2005, for purposes of the effective date. Notwithstanding the foregoing, an amount to which the service provider had a legally binding right before January 1, 2005, but for which the service provider was required to continue performing services to retain the right only through the completion of the payroll period (as defined in §1.409A-1(b)(3)) that includes December 31, 2004, is not treated as subject to a requirement to perform further services (or a substantial risk of forfeiture) for purposes of the effective date. For purposes of this paragraph (a)(2), a stock option, stock appreciation right, or similar compensation that on or before December 31, 2004, was immediately exercisable for cash or substantially vested property (as defined in §1.83-3(b)) is treated as earned and vested, regardless of whether the right would terminate if the service provider ceased providing services for the service recipient.

(3) *Calculation of amount of compensation deferred for statutory effective date purposes—(i) Nonaccount balance plans.* The amount of compensation deferred before January 1, 2005, under a nonqualified deferred compensation plan that is a nonaccount balance plan (as defined in §1.409A-1(c)(2)(i)(C)), equals the present value of the amount to which the service provider would have been entitled under the plan if the service provider voluntarily terminated services without cause on December 31, 2004, and received a payment of the benefits available from the plan on the earliest possible date allowed under the plan to receive a payment of benefits following the termination of services, and received the benefits in the form with the maximum value. Notwithstanding the foregoing, for any subsequent taxable year of the service provider, the grandfathered amount may increase to equal the present

value of the benefit the service provider actually becomes entitled to, in the form and at the time actually paid, determined under the terms of the plan (including applicable limits under the Internal Revenue Code), as in effect on October 3, 2004, without regard to any further services rendered by the service provider after December 31, 2004, or any other events affecting the amount of or the entitlement to benefits (other than a participant election with respect to the time or form of an available benefit). For purposes of calculating the present value of a benefit under this paragraph (c)(3)(i), reasonable actuarial assumptions and methods must be used. Whether assumptions and methods are reasonable for this purpose is determined as of each date the benefit is valued for purposes of determining the grandfathered benefit, provided that any reasonable actuarial assumptions and methods that were used by the service recipient with respect to such benefit as of December 31, 2004, will continue to be treated as reasonable assumptions and methods for purposes of calculating the grandfathered benefit. Actuarial assumptions and methods will be presumed reasonable if they are the same as those used to value benefits under a qualified plan sponsored by the service recipient the benefits under which are part of the benefit formula under, or otherwise impact the amount of benefits under, the nonaccount balance nonqualified deferred compensation plan.

(ii) *Account balance plans.* The amount of compensation deferred before January 1, 2005, under a nonqualified deferred compensation plan that is an account balance plan (as defined in §1.409A-1(c)(2)(i)(A)), equals the portion of the service provider's account balance as of December 31, 2004, the right to which was earned and vested (as defined in paragraph (a)(2) of this section) as of December 31, 2004, plus any future contributions to the account, the right to which was earned and vested (as defined in paragraph (a)(2) of this section) as of December 31, 2004, to the extent such contributions are actually made.

(iii) *Equity-based compensation plans.* For purposes of determining the amounts deferred before January 1, 2005, under an equity-based compensation plan, the rules of paragraph (a)(3)(ii) of this section governing account balance plans are applied

except that the account balance is deemed to be the amount of the payment available to the service provider on December 31, 2004 (or that would be available to the service provider if the right were immediately exercisable) the right to which is earned and vested (as defined in paragraph (a)(2) of this section) as of December 31, 2004. For this purpose, the payment available to the service provider excludes any exercise price or other amount that must be paid by the service provider.

(iv) *Earnings.* Earnings on amounts deferred under a plan before January 1, 2005, include only income (whether actual or notional) attributable to the amounts deferred under a plan as of December 31, 2004, or to such income. For example, notional interest earned under the plan on amounts deferred in an account balance plan as of December 31, 2004, generally will be treated as earnings on amounts deferred under the plan before January 1, 2005. Similarly, an increase in the amount of payment available pursuant to a stock option, stock appreciation right, or other equity-based compensation above the amount of payment available as of December 31, 2004, due to appreciation in the underlying stock after December 31, 2004, or accrual of other earnings such as dividends, is treated as earnings on the amount deferred. In the case of a nonaccount balance plan, earnings include the increase, due solely to the passage of time, in the present value of the future payments to which the service provider has obtained a legally binding right, the present value of which constituted the amounts deferred under the plan before January 1, 2005. Thus, for each year, there will be an increase (determined using the same interest rate used to determine the amounts deferred under the plan before January 1, 2005) resulting from the shortening of the discount period before the future payments are made, plus, if applicable, an increase in the present value resulting from the service provider's survivorship during the year. However, an increase in the potential benefits under a nonaccount balance plan due to, for example, an application of an increase in compensation after December 31, 2004, to a final average pay plan or subsequent eligibility for an early retirement subsidy, does not constitute earnings on the amounts deferred under the plan before January 1, 2005.

(v) *Definition of plan.* For purposes of paragraphs (a)(1), (2), and (3) of this section, the term "plan" has the meaning provided in §1.409A-1(c), except that the plan aggregation rules do not apply for purposes of the actuarial assumptions and methods used in paragraph (a)(3)(i) of this section. Accordingly, different reasonable actuarial assumptions and methods may be used to calculate the amounts deferred by a service provider in two different agreements, methods, programs, or other arrangements each of which constitutes a nonaccount balance plan.

(4) *Material modifications*—(i) *In general.* Except as otherwise provided, a modification of a plan is a material modification if a benefit or right existing as of October 3, 2004, is materially enhanced or a new material benefit or right is added, and such material enhancement or addition affects amounts earned and vested before January 1, 2005. Such material benefit enhancement or addition is a material modification whether it occurs pursuant to an amendment or to the service recipient's exercise of discretion under the terms of the plan. For example, an amendment to a plan to add a provision that payments of deferred amounts earned and vested before January 1, 2005, may be allowed upon request if service providers are required to forfeit 20 percent of the amount of the payment (a haircut) would be a material modification to the plan. Similarly, a material modification would occur if a service recipient exercised discretion to accelerate vesting of a benefit under the plan to a date on or before December 31, 2004. However, it is not a material modification for a service recipient to exercise discretion 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. It is not a material modification for a service provider to exercise a right permitted under the plan as in effect on October 3, 2004. The amendment of a plan to bring the plan into compliance with the provisions of section 409A will not be treated as a material modification. However, a plan amendment or the exercise of discretion under the terms of the plan that materially enhances an existing benefit or right or adds a new material benefit or right will be considered a material modification even if the enhanced or added benefit would be permitted under

section 409A. For example, the addition of a right to a payment upon an unforeseeable emergency of an amount earned and vested before January 1, 2005, would be considered a material modification. The reduction of an existing benefit is not a material modification. For example, the removal of a haircut provision generally would not constitute a material modification. The following modifications also are not material modifications for purposes of this paragraph (a)(4)(i):

(A) The establishment of or contributions to a trust or other arrangement from which benefits under the plan are to be paid is not a material modification of the plan, provided that the contribution to the trust or other arrangement would not otherwise cause an amount to be includible in the service provider's gross income.

(B) The modification of a provision requiring the immediate cancellation of a current deferral election, to require the cancellation of deferrals for the same length of time beginning with the first date at which the application of such cancellation would not violate section 409A (for example, the first date of the service provider's first taxable year following the cancellation).

(C) Compliance with a domestic relations order (as defined in §1.409A-3(j)(4)(ii)) with respect to payments to an individual other than the service provider, or an amendment to a plan to require compliance with a domestic relations order with respect to payments to an individual other than the service provider.

(D) The modification of a plan providing a life annuity form of payment to permit an election between the existing life annuity form of payment and other forms of annuity payments that would be treated as a single form of payment with the existing life annuity form of payment under §1.409A-2(b)(2)(ii).

(E) The modification of a grandfathered plan to add a limited cashout feature consistent with §1.409A-3(j)(4)(v) (exception to prohibition on accelerated payments).

(ii) *Adoptions of new plans.* It is presumed that 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, constitutes a material modification of a plan. However, the presumption may be rebutted by demon-

strating that the adoption of the plan or grant of the additional benefit was consistent with the service recipient's historical compensation practices. For example, the presumption that the grant of a discounted stock option on November 1, 2004, is a material modification of a plan may be rebutted by demonstrating that the grant was consistent with the historic practice of granting substantially similar discounted stock options (both as to terms and amounts) each November for a significant number of years. Notwithstanding paragraph (a)(4)(i) of this section and this paragraph (a)(4)(ii), the grant of an additional benefit under an existing plan that consists of a deferral of additional compensation not otherwise provided under the plan as of October 3, 2004, will be treated as a material modification of the plan only as to the additional deferral of compensation, if the plan explicitly identifies the additional deferral of compensation and provides that the additional deferral of compensation is subject to section 409A. Accordingly, amendments to conform a plan to the requirements of section 409A with respect to deferrals under a plan occurring after December 31, 2004, will not constitute a material modification of the plan with respect to amounts deferred that are earned and vested on or before December 31, 2004, provided that there is no concurrent material modification with respect to the amount of, or rights to, amounts deferred that were earned and vested on or before December 31, 2004. Similarly, a grant of an additional benefit under a new plan adopted after October 3, 2004, and before January 1, 2005, will not be treated as a material modification of an existing plan to the extent that the new plan explicitly identifies additional deferrals of compensation and provides that the additional deferrals of compensation are subject to section 409A.

(iii) *Suspension or termination of a plan.* A cessation of deferrals under, or termination of, a plan, pursuant to the provisions of such plan, is not a material modification. Amending a plan to provide participants an election whether to terminate participation in a plan generally constitutes a material modification of the plan.

(iv) *Changes to investment measures—account balance plans.* With

respect to an account balance plan (as defined in §1.409A-1(c)(2)(i)(A)), it is not a material modification to change a notional investment measure to, or to add to an existing investment measure, an investment measure that qualifies as a predetermined actual investment within the meaning of §31.3121(v)(2)-1(d)(2) of this chapter or, for any given taxable year, reflects a reasonable rate of interest (determined in accordance with §31.3121(v)(2)-1(d)(2)(i)(C) of this chapter). For this purpose, if with respect to an amount deferred for a period, a plan provides for a fixed rate of interest to be credited, and the rate is to be reset under the plan at a specified future date that is not later than the end of the fifth taxable year that begins after the beginning of the period, the rate is reasonable at the beginning of the period, and the rate is not changed before the reset date, then the rate will be treated as reasonable in all future periods before the reset date.

(v) *Stock rights.* The modification, extension, or renewal of a stock right will not constitute a material modification of the stock right, if the modification, extension, or renewal would not be treated as the grant of a new stock right under §1.409A-1(b)(5)(v)(A), and would not result in the stock right being treated as having had a deferral feature from the date of grant pursuant to §1.409A-1(b)(5)(v)(C).

(vi) *Rescission of modifications.* Any modification to the terms of a plan that would inadvertently result in treatment as a material modification under this section is not considered a material modification of the plan to the extent the modification in the terms of the plan is rescinded by the earlier of a date before the right is exercised (if the change grants a discretionary right) or the last day of the taxable year of the service provider during which such change occurred. Thus, for example, if a service recipient modifies the terms of a plan on March 1 to allow an individual employee to elect a new change in the time or form of payment without realizing that such a change constituted a material modification that would subject the plan to the requirements of section 409A, and the modification is rescinded on November 1, then if no change in the time or form of payment has been made pursuant to the modification before November 1, the plan

is not considered materially modified under this section.

(vii) *Definition of plan.* For purposes of this paragraph (a)(4), the term "plan" has the same meaning provided in §1.409A-1(c), except that the plan aggregation rules of §1.409A-1(c)(2) do not apply.

(b) *Regulatory applicability date.* §1.409A-1, §1.409A-2, §1.409A-3 and this section are applicable for taxable years beginning on or after January 1, 2008.

Kevin M. Brown,
*Deputy Commissioner for
Services and Enforcement.*

Approved March 20, 2007.

Eric Solomon,
*Assistant Secretary
of the Treasury.*

(Filed by the Office of the Federal Register on April 10, 2007, 8:45 a.m., and published in the issue of the Federal Register for April 17, 2007, 72 F.R. 19234)

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2007. See Rev. Rul. 2007-29, page 1223.

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2007. See Rev. Rul. 2007-29, page 1223.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2007. See Rev. Rul. 2007-29, page 1223.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of May 2007. See Rev. Rul. 2007-29, page 1223.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2007. See Rev. Rul. 2007-29, page 1223.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of May 2007. See Rev. Rul. 2007-29, page 1223.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2007. See Rev. Rul. 2007-29, page 1223.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2007. See Rev. Rul. 2007-29, page 1223.

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also Sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 642, 1274, 1288, and other sections of the Code, tables set forth the rates for May 2007.

Rev. Rul. 2007-29

This revenue ruling provides various prescribed rates for federal income

tax purposes for May 2007 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 2007-29 TABLE 1
Applicable Federal Rates (AFR) for May 2007

| | <i>Period for Compounding</i> | | | |
|-------------------|-------------------------------|-------------------|------------------|----------------|
| | <i>Annual</i> | <i>Semiannual</i> | <i>Quarterly</i> | <i>Monthly</i> |
| <i>Short-term</i> | | | | |
| AFR | 4.85% | 4.79% | 4.76% | 4.74% |
| 110% AFR | 5.34% | 5.27% | 5.24% | 5.21% |
| 120% AFR | 5.83% | 5.75% | 5.71% | 5.68% |
| 130% AFR | 6.33% | 6.23% | 6.18% | 6.15% |
| <i>Mid-term</i> | | | | |
| AFR | 4.62% | 4.57% | 4.54% | 4.53% |
| 110% AFR | 5.09% | 5.03% | 5.00% | 4.98% |
| 120% AFR | 5.56% | 5.48% | 5.44% | 5.42% |
| 130% AFR | 6.03% | 5.94% | 5.90% | 5.87% |
| 150% AFR | 6.98% | 6.86% | 6.80% | 6.76% |
| 175% AFR | 8.16% | 8.00% | 7.92% | 7.87% |
| <i>Long-term</i> | | | | |
| AFR | 4.90% | 4.84% | 4.81% | 4.79% |
| 110% AFR | 5.39% | 5.32% | 5.29% | 5.26% |
| 120% AFR | 5.89% | 5.81% | 5.77% | 5.74% |
| 130% AFR | 6.39% | 6.29% | 6.24% | 6.21% |

REV. RUL. 2007-29 TABLE 2

Adjusted AFR for May 2007

Period for Compounding

| | <i>Annual</i> | <i>Semiannual</i> | <i>Quarterly</i> | <i>Monthly</i> |
|-------------------------|---------------|-------------------|------------------|----------------|
| Short-term adjusted AFR | 3.47% | 3.44% | 3.43% | 3.42% |
| Mid-term adjusted AFR | 3.61% | 3.58% | 3.56% | 3.55% |
| Long-term adjusted AFR | 4.11% | 4.07% | 4.05% | 4.04% |

REV. RUL. 2007-29 TABLE 3

Rates Under Section 382 for May 2007

| | |
|--|-------|
| Adjusted federal long-term rate for the current month | 4.11% |
| Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.) | 4.18% |

REV. RUL. 2007-29 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for May 2007

| | |
|--|-------|
| Appropriate percentage for the 70% present value low-income housing credit | 8.11% |
| Appropriate percentage for the 30% present value low-income housing credit | 3.47% |

REV. RUL. 2007-29 TABLE 5

Rate Under Section 7520 for May 2007

| | |
|---|------|
| Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest | 5.6% |
|---|------|

Section 1288.—Treatment of Original Issue Discount on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2007. See Rev. Rul. 2007-29, page 1223.

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2007. See Rev. Rul. 2007-29, page 1223.

Section 7872.—Treatment of Loans With Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2007. See Rev. Rul. 2007-29, page 1223.

Part III. Administrative, Procedural, and Miscellaneous

26 CFR 601.601: Rules and regulations.
(Also Part I, §§ 25, 103, 143; 1.25-4T, 1.103-1,
6a.103A-2.)

Rev. Proc. 2007-31

SECTION 1. PURPOSE

This revenue procedure provides guidance with respect to the United States and area median gross income figures that are to be used by issuers of qualified mortgage bonds, as defined in § 143(a) of the Internal Revenue Code, and issuers of mortgage credit certificates, as defined in § 25(c), in computing the housing cost/income ratio described in § 143(f)(5).

SECTION 2. BACKGROUND

.01 Section 103(a) provides that, except as provided in § 103(b), gross income does not include interest on any state or local bond. Section 103(b)(1) provides that § 103(a) shall not apply to any private activity bond that is not a qualified bond (within the meaning of § 141). Section 141(e) provides that the term “qualified bond” includes any private activity bond that (1) is a qualified mortgage bond, (2) meets the applicable volume cap requirements under § 146, and (3) meets the applicable requirements under § 147.

.02 Section 143(a)(1) provides that the term “qualified mortgage bond” means a bond that is issued as part of a “qualified mortgage issue”. Section 143(a)(2)(A) provides that the term “qualified mortgage issue” means an issue of one or more bonds by a state or political subdivision thereof, but only if (i) all proceeds of the issue (exclusive of issuance costs and a reasonably required reserve) are to be used to finance owner-occupied residences; (ii) the issue meets the requirements of subsections (c), (d), (e), (f), (g), (h), (i), and (m)(7) of § 143; (iii) the issue does not meet the private business tests of paragraphs (1) and (2) of § 141(b); and (iv) with respect to amounts received more than 10 years after the date of issuance, repayments of \$250,000 or more of principal on financing provided by the issue are used not later than the close of the first semi-annual period beginning after the

date the prepayment (or complete repayment) is received to redeem bonds that are part of the issue.

.03 Section 143(f) imposes eligibility requirements concerning the maximum income of mortgagors for whom financing may be provided by qualified mortgage bonds. Section 25(c)(2)(A)(iii)(IV) provides that recipients of mortgage credit certificates must meet the income requirements of § 143(f). Generally, under §§ 143(f)(1) and 25(c)(2)(A)(iii)(IV), these income requirements are met only if all owner-financing under a qualified mortgage bond and all certified indebtedness amounts under a mortgage credit certificate program are provided to mortgagors whose family income is 115 percent or less of the applicable median family income. Under § 143(f)(6), the income limitation is reduced to 100 percent of the applicable median family income if there are fewer than three individuals in the family of the mortgagor.

.04 Section 143(f)(4) provides that the term “applicable median family income” means the greater of (A) the area median gross income for the area in which the residence is located, or (B) the statewide median gross income for the state in which the residence is located.

.05 Section 143(f)(5) provides for an upward adjustment of the income limitations in certain high housing cost areas. Under § 143(f)(5)(C), a high housing cost area is a statistical area for which the housing cost/income ratio is greater than 1.2. The housing cost/income ratio is determined under § 143(f)(5)(D) by dividing (a) the applicable housing price ratio by (b) the ratio that the area median gross income bears to the median gross income for the United States. The applicable housing price ratio is the new housing price ratio (new housing average purchase price for the area divided by the new housing average purchase price for the United States) or the existing housing price ratio (existing housing average area purchase price divided by the existing housing average purchase price for the United States), whichever results in the housing cost/income ratio being closer to 1. This income adjustment applies only to bonds issued, and nonissued bond amounts elected, after

December 31, 1988. See § 4005(h) of the Technical and Miscellaneous Revenue Act of 1988, 1988-3 C.B. 1, 311 (1988).

.06 The Department of Housing and Urban Development (HUD) has computed the median gross income for the United States, the states, and statistical areas within the states. The income information was released to the HUD regional offices on March 20, 2007, and may be obtained by calling the HUD reference service at 1-800-245-2691. The income information is also available at HUD’s World Wide Web site, <http://huduser.org/datasets/il.html>, which provides a menu from which you may select the year and type of data of interest. The Internal Revenue Service annually publishes the median gross income for the United States.

.07 The most recent nationwide average purchase prices and average area purchase price safe harbor limitations were published on March 26, 2007, in Rev. Proc. 2007-26, 2007-13 I.R.B. 814.

SECTION 3. APPLICATION

.01 When computing the housing cost/income ratio under § 143(f)(5), issuers of qualified mortgage bonds and mortgage credit certificates must use as the median gross income for the United States either (1) the \$59,600 median gross income figure released to the HUD regional offices on March 8, 2006, or (2) the \$59,000 median gross income figure released to the HUD regional offices on March 20, 2007. See § 2.06 of this revenue procedure.

.02 When computing the housing cost/income ratio under § 143(f)(5), issuers of qualified mortgage bonds and mortgage credit certificates generally must use the area median gross income figures released by HUD on March 20, 2007. See § 2.06 of this revenue procedure. However, for any area for which the March 20, 2007 income figure is lower than the income figure released by HUD on March 8, 2006 for the same area, issuers may use the higher figure released on March 8, 2006, when computing the housing cost/income ratio under § 143(f)(5).

SECTION 4. EFFECT ON OTHER REVENUE PROCEDURES

.01 Rev. Proc. 2006–20, 2006–17 I.R.B. 841, is obsolete except as provided in § 5.02 of this revenue procedure.

.02 This revenue procedure does not affect the effective date provisions of Rev. Rul. 86–124, 1986–2 C.B. 27. Those effective date provisions will remain operative at least until the Service publishes a new revenue ruling that conforms the approach to effective dates set forth in Rev. Rul. 86–124 to the general approach taken in this revenue procedure. However, when determining the income requirements under § 143(f), for any state or area for which the March 20, 2007 statewide or area median gross income figure is lower than the income figure released by HUD on March 8, 2006, for the same state or area, is-

suers may use the higher figure released on March 8, 2006, until 30 days after release by HUD of updated income limits.

SECTION 5. EFFECTIVE DATES

.01 Issuers must use the United States and area median gross income figures specified in § 3 of this revenue procedure for commitments to provide financing that are made, or (if the purchase precedes the financing commitment) for residences that are purchased, in the period that begins on March 20, 2007, and ends on the date when these United States and area median gross income figures are rendered obsolete by a new revenue procedure.

.02 Notwithstanding § 5.01 of this revenue procedure, issuers also may continue to rely on the United States and area median gross income figures specified in Rev.

Proc. 2006–20 with respect to bonds originally sold and nonissued bond amounts elected not later than May 17, 2007, if the commitments or purchases described in § 5.01 are made not later than July 16, 2007. Issuers also may continue to rely on the United States and area median gross income figures specified in Rev. Proc. 2006–20, to the extent allowed under §§ 3.01 and 3.02 of this revenue procedure.

DRAFTING INFORMATION

The principal author of this revenue procedure is David White of the Office of Assistant Chief Counsel (Exempt Organizations/Employment Tax/Government Entities). For further information regarding this revenue procedure, contact Mr. White at (202) 622–3980 (not a toll-free call).

Part IV. Items of General Interest

Announcement of Disciplinary Actions Involving Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries — Suspensions, Censures, Disbarments, and Resignations

Announcement 2007-41

Under Title 31, Code of Federal Regulations, Part 10, attorneys, certified public accountants, enrolled agents, and enrolled actuaries may not accept assistance from, or assist, any person who is under disbarment or suspension from practice before the Internal Revenue Service if the assistance relates to a matter constituting practice before the Internal Revenue Service and may not knowingly aid or abet another

person to practice before the Internal Revenue Service during a period of suspension, disbarment, or ineligibility of such other person.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify persons to whom these restrictions apply, the Director, Office of Professional Responsibility, will announce in the Internal Revenue Bulletin

their names, their city and state, their professional designation, the effective date of disciplinary action, and the period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks.

Consent Suspensions From Practice Before the Internal Revenue Service

Under Title 31, Code of Federal Regulations, Part 10, an attorney, certified public accountant, enrolled agent, or enrolled actuary, in order to avoid the institution or conclusion of a proceeding for his or her disbarment or suspension from practice before the Internal Revenue Service,

may offer his or her consent to suspension from such practice. The Director, Office of Professional Responsibility, in his discretion, may suspend an attorney, certified public accountant, enrolled agent, or enrolled actuary in accordance with the consent offered.

The following individuals have been placed under consent suspension from practice before the Internal Revenue Service:

| Name | Address | Designation | Date of Suspension |
|-----------------------|----------------|-------------|---|
| Hankinson, Eugene M. | Somerset, PA | CPA | Indefinite
from
November 15, 2006 |
| Canzano, Richard M. | Winchester, MA | Attorney | Indefinite
from
November 20, 2006 |
| Sims, Jr., Lionel | Houston, TX | CPA | Indefinite
from
November 20, 2006 |
| Wendekier, Raymond J. | Patton, PA | Attorney | Indefinite
from
November 21, 2006 |
| Golden, Larry | Hinesville, GA | CPA | Indefinite
from
November 28, 2006 |

| Name | Address | Designation | Date of Suspension |
|-------------------------|------------------|----------------|---|
| Lane, David B. | Hanover, MA | Attorney | Indefinite
from
November 28, 2006 |
| Brown, Arthur I. | Miami, FL | CPA | Indefinite
from
December 1, 2006 |
| Frisk, Daniel J. | Fargo, ND | Attorney | Indefinite
from
December 1, 2006 |
| Small, Kenneth A. | McMurray, PA | CPA | Indefinite
from
December 1, 2006 |
| Vazquez, Sonya M. | Port Orchard, WA | CPA | Indefinite
from
December 1, 2006 |
| Swistak, Anthony | Adams, MA | Enrolled Agent | Indefinite
from
December 6, 2006 |
| Lenahan, Jr., Robert J. | Elizabeth, NJ | Attorney | Indefinite
from
December 11, 2006 |
| Hayes, Richard A. | Havervill, MA | Attorney | Indefinite
from
December 14, 2006 |
| Scheller, Stephen M. | Coppell, TX | CPA | Indefinite
from
December 15, 2006 |
| Wilson, James M. | Berlin, NJ | CPA | Indefinite
from
December 15, 2006 |
| Franzese, Joseph P. | Winthrop, MA | Attorney | Indefinite
from
December 18, 2006 |
| Black, Charles C. | Marietta, GA | Attorney | Indefinite
from
January 1, 2007 |
| Enright, III, Robert A. | Naples, FL | Attorney | Indefinite
from
January 1, 2007 |
| Fromovitz, Norman M. | Brooklyn, NY | CPA | Indefinite
from
January 1, 2007 |
| Saylor, Mary A. | Iowa City, IA | Enrolled Agent | Indefinite
from
January 1, 2007 |

| Name | Address | Designation | Date of Suspension |
|-----------------------|---------------------|----------------|--|
| Seeherman, Alan | Wynnewood, PA | CPA | Indefinite
from
January 1, 2007 |
| Beistel, Theodore L. | Canton, OH | CPA | Indefinite
from
January 3, 2007 |
| Myers, Robert J. | Fairport Harbor, OH | CPA | Indefinite
from
January 9, 2007 |
| Burrus, Robert V. | Valparaiso, IN | CPA | Indefinite
from
January 22, 2007 |
| Patterson, Douglas W. | Newburgh, IN | Attorney | Indefinite
from
January 31, 2007 |
| Lang, Jeffrey H. | Fishers, IN | CPA | Indefinite
from
January 22, 2007 |
| Chickering, David | Vermillion, SD | CPA | February 5, 2007
to
November 4, 2007 |
| Moss, Steve E. | Henderson, NC | CPA | Indefinite
from
February 5, 2007 |
| Hazlip, Kevin | Orange Park, FL | Enrolled Agent | Indefinite
from
February 10, 2007 |
| Adelson, Robert A. | Newton, MA | Attorney | Indefinite
from
February 15, 2007 |
| Boyer, Daniel D. | North Judson, IN | CPA | Indefinite
from
February 15, 2007 |
| LaRusso, Anthony J. | North Caldwell, NJ | Attorney | Indefinite
from
February 15, 2007 |
| Martin, Spencer R. | Lancaster, PA | CPA | Indefinite
from
February 15, 2007 |
| Hursh, Stephanie S. | Brush Prairie, WA | Enrolled Agent | Indefinite
from
February 20, 2007 |
| Guidera, George C. | Weston, CT | Attorney | Indefinite
from
February 26, 2007 |
| Ruth, Christopher A. | Cypress, CA | CPA | Indefinite
from
February 27, 2007 |

| Name | Address | Designation | Date of Suspension |
|-------------------------|------------------|----------------|--------------------------------------|
| Elias, Lenard S. | El Cajon, CA | Enrolled Agent | Indefinite
from
March 1, 2007 |
| Ikeji, Chuck | Orlando, FL | CPA | Indefinite
from
March 1, 2007 |
| Lewis, Craig S. | Savannah, GA | CPA | Indefinite
from
March 1, 2007 |
| Sloan, Eric R. | Brighton, MI | CPA | Indefinite
from
March 1, 2007 |
| Gostomski, Michael | Stamford, CT | CPA | Indefinite
from
March 5, 2007 |
| Hafer, Charles J. | Hamburg, PA | Enrolled Agent | Indefinite
from
March 5, 2007 |
| Jones, Phillip G. | Andalusia, AL | Enrolled Agent | Indefinite
from
March 7, 2007 |
| Agashiwala, Mahesh J. | New York, NY | CPA | Indefinite
from
March 22, 2007 |
| Berndgen, Michael | Plantation, FL | CPA | Indefinite
from
April 1, 2007 |
| Grahn, Charles R. | Indianapolis, IN | Attorney | Indefinite
from
April 1, 2007 |
| Shaw, G. Joyce | Hebron, KY | Enrolled Agent | Indefinite
from
April 1, 2007 |
| Pikaart, Jr., Edward H. | N. Branford, CT | CPA | Indefinite
from
April 10, 2007 |
| Kelley, Richard S. | Beverly, MA | Attorney | Indefinite
from
May 1, 2007 |
| Crabtree, Michael L. | San Dimas, CA | Enrolled Agent | Indefinite
from
May 15, 2007 |
| Hausmann, Mark D. | Troy, NY | Attorney | Indefinite
from
May 15, 2007 |

Expedited Suspensions From Practice Before the Internal Revenue Service

Under Title 31, Code of Federal Regulations, Part 10, the Director, Office of Professional Responsibility, is authorized to immediately suspend from practice before the Internal Revenue Service any practitioner who, within five years from the date

the expedited proceeding is instituted (1) has had a license to practice as an attorney, certified public accountant, or actuary suspended or revoked for cause or (2) has been convicted of certain crimes.

The following individuals have been placed under suspension from practice before the Internal Revenue Service by virtue of the expedited proceeding provisions:

| Name | Address | Designation | Date of Suspension |
|----------------------|---------------------|----------------|---|
| Hatchett, William M. | Pontiac, MI | Attorney | Indefinite
from
November 13, 2006 |
| Jacobs, Mark L. | Jackson Heights, NY | Attorney | Indefinite
from
November 21, 2006 |
| Sylver, Peter T. | E. Longmeadow, MA | Attorney | Indefinite
from
November 21, 2006 |
| Portlock, David R. | Pensacola, FL | Enrolled Agent | Indefinite
from
November 27, 2006 |
| Ascher, Michael P. | North Port, FL | Attorney | Indefinite
from
November 28, 2006 |
| Barrett, Norman W. | Dover, DE | CPA | Indefinite
from
November 28, 2006 |
| Burd, Gene | Houston, TX | Attorney | Indefinite
from
November 28, 2006 |
| Caceres, Carlos H. | Silver Spring, MD | Attorney | Indefinite
from
November 28, 2006 |
| Carrabotta, Peter S. | Niles, IL | Attorney | Indefinite
from
November 28, 2006 |
| Davis, Carleton W. | St. Louis, MO | Attorney | Indefinite
from
November 28, 2006 |
| Frasier, Roland B. | Rancho Santa Fe, CA | Attorney | Indefinite
from
November 28, 2006 |
| Hubbard, Edward | Chicago, IL | Attorney | Indefinite
from
November 28, 2006 |

| Name | Address | Designation | Date of Suspension |
|----------------------|-------------------|-------------|---|
| Hynes, Richard W. | Brookline, MA | Attorney | Indefinite
from
November 28, 2006 |
| Johnson, Barbara C. | Andover, MA | Attorney | Indefinite
from
November 28, 2006 |
| Konas, Theodore V. | Lancaster, PA | CPA | Indefinite
from
November 28, 2006 |
| Korson, Daniel M. | Muskegon, MI | CPA | Indefinite
from
November 28, 2006 |
| Lee, III, Norman J. | Collegeville, PA | Attorney | Indefinite
from
November 28, 2006 |
| Loiben, Alan A. | Skokie, IL | Attorney | Indefinite
from
November 28, 2006 |
| McGarry, Thomas H. | Denver, CO | Attorney | Indefinite
from
November 28, 2006 |
| Roberts, Quinton D. | Elkridge, MD | Attorney | Indefinite
from
November 28, 2006 |
| Schofield, Peter L. | Spencer, MA | Attorney | Indefinite
from
November 28, 2006 |
| Shultz, Ryan K. | Mitchell, NE | Attorney | Indefinite
from
November 28, 2006 |
| Stenger, Jeanne P. | Temecula, CA | Attorney | Indefinite
from
November 28, 2006 |
| Wood, Gary K. | Edina, MN | Attorney | Indefinite
from
November 28, 2006 |
| Bakare, Adigun S. | Laurel, MD | Attorney | Indefinite
from
December 6, 2006 |
| Biagini, Marc J. | Downers Grove, IL | Attorney | Indefinite
from
December 6, 2006 |
| Birchall, Richard G. | Brewster, MA | Attorney | Indefinite
from
December 6, 2006 |

| Name | Address | Designation | Date of Suspension |
|-----------------------------|---------------------|-------------|---|
| Brown, Edward E. | Indianapolis, IN | Attorney | Indefinite
from
December 6, 2006 |
| Cunningham, Jr., Shirley A. | Ft. Lauderdale, FL | Attorney | Indefinite
from
December 6, 2006 |
| Docherty, Scott R. | Branson West, MO | Attorney | Indefinite
from
December 6, 2006 |
| Dressler, Peter P. | West Chicago, IL | Attorney | Indefinite
from
December 6, 2006 |
| Henry, William J. | Irvington, NJ | Attorney | Indefinite
from
December 6, 2006 |
| Hubbard, Cynthia A. | Geneva, IL | Attorney | Indefinite
from
December 6, 2006 |
| Jackson, Jr., Donald H. | Hanover, MA | Attorney | Indefinite
from
December 6, 2006 |
| Katz, Norman H. | Owings Mills, MD | Attorney | Indefinite
from
December 6, 2006 |
| Lakin, Leonard S. | Wellesley Hills, MA | Attorney | Indefinite
from
December 6, 2006 |
| McGreevy, Jacqueline K. | Carbondale, CO | Attorney | Indefinite
from
December 6, 2006 |
| Zepp, Dale D. | Ferguson, MO | Attorney | Indefinite
from
December 6, 2006 |
| Triplett, Austin H. | Homewood, IL | Attorney | Indefinite
from
December 11, 2006 |
| Murphy, Patrick W. | Honolulu, HI | Attorney | Indefinite
from
December 11, 2006 |
| Cronin, Jr., Edward M. | Cambridge, MA | Attorney | Indefinite
from
December 11, 2006 |
| Christof, Kevin F. | Santa Monica, CA | Attorney | Indefinite
from
December 21, 2006 |
| Heath, Kenneth J. | Canaan, VT | CPA | Indefinite
from
December 21, 2006 |

| Name | Address | Designation | Date of Suspension |
|--------------------------|-------------------|-------------|---|
| Madigan, Brian C. | Binghamton, NY | Attorney | Indefinite
from
December 21, 2006 |
| Malloy, Terry P. | Tulsa, OK | Attorney | Indefinite
from
December 21, 2006 |
| Baynes, Robert M. | Indianapolis, IN | CPA | Indefinite
from
December 27, 2006 |
| Ceresa, Richard A. | Woodbridge, CA | CPA | Indefinite
from
December 27, 2006 |
| Crews, Richard A. | Henderson, CO | Attorney | Indefinite
from
December 27, 2006 |
| Menkveld, Paul G. | Tucson, AZ | Attorney | Indefinite
from
December 27, 2006 |
| Worischek, Joseph H. | Tempe, AZ | Attorney | Indefinite
from
December 27, 2006 |
| Brown, Kirk P. | Pueblo, CO | Attorney | Indefinite
from
December 28, 2006 |
| Dowling, Stanley W. | Scotts Valley, CA | CPA | Indefinite
from
December 28, 2006 |
| Simmons, Henry L. | Greensboro, NC | CPA | Indefinite
from
December 28, 2006 |
| Steele, Regina D. | San Diego, CA | Attorney | Indefinite
from
December 29, 2006 |
| Craig, III, William A. | Austin, TX | Attorney | Indefinite
from
January 1, 2007 |
| Acker, Thomas R. | Hollis Center, ME | Attorney | Indefinite
from
January 8, 2007 |
| Baxter, Laura M. | Monee, IL | CPA | Indefinite
from
January 8, 2007 |
| Herald, Sally J. | Cold Spring, KY | Attorney | Indefinite
from
January 8, 2007 |
| Klapheke, II, William T. | Bowling Green, KY | Attorney | Indefinite
from
January 8, 2007 |

| Name | Address | Designation | Date of Suspension |
|-------------------------|--------------------|-------------|--|
| McCarthy, Charles C. | Encino, CA | Attorney | Indefinite
from
January 8, 2007 |
| Bolling, Darius C. | Chicago, IL | CPA | Indefinite
from
January 10, 2007 |
| Breitlauch, Linda | Saylorsburg, PA | Attorney | Indefinite
from
January 10, 2007 |
| Coddington, Paul F. | Concord, NH | Attorney | Indefinite
from
January 10, 2007 |
| Davis, Jr., William E. | Pinehurst, TX | CPA | Indefinite
from
January 10, 2007 |
| Esola, Louis A. | Greensburg, PA | CPA | Indefinite
from
January 10, 2007 |
| Finch, Judith A. | Walnut Creek, CA | Attorney | Indefinite
from
January 10, 2007 |
| Jeing, Thomas C. | San Francisco, CA | Attorney | Indefinite
from
January 10, 2007 |
| Ledbetter, Dean D. | Pelham, AL | CPA | Indefinite
from
January 10, 2007 |
| McDiarmid, Katherine B. | Greensboro, NC | Attorney | Indefinite
from
January 10, 2007 |
| Mills, George P. | Oceanside, CA | Attorney | Indefinite
from
January 10, 2007 |
| Rather, James L. | Irvine, CA | Attorney | Indefinite
from
January 10, 2007 |
| Rivera, Eduardo M. | Torrance, CA | Attorney | Indefinite
from
January 10, 2007 |
| Stepovich, Michael A. | Fairbanks, AK | Attorney | Indefinite
from
January 10, 2007 |
| Ulbrich, David L. | Woodland Hills, CA | CPA | Indefinite
from
January 10, 2007 |
| Swanson, Todd-Ellis | Greenville, SC | CPA | Indefinite
from
January 20, 2007 |

| Name | Address | Designation | Date of Suspension |
|---------------------------|------------------|-------------|---|
| Rubin, Deborah L. | Delray Beach, FL | Attorney | Indefinite
from
January 26, 2007 |
| Wood, Brent E. | Cary, NC | Attorney | Indefinite
from
January 26, 2007 |
| Currin, Samuel T. | Raleigh, NC | Attorney | Indefinite
from
February 7, 2007 |
| Lupo, Robert N. | Weston, MA | Attorney | Indefinite
from
February 20, 2007 |
| Taggart, Lawrence W. | El Cajon, CA | Attorney | Indefinite
from
March 7, 2007 |
| Fife, III, James H. | Schererville, IN | Attorney | Indefinite
from
March 8, 2007 |
| Katsis, Kevin G. | Riverside, IL | Attorney | Indefinite
from
March 8, 2007 |
| O'Driscoll, Dennis M. | Quincy, MA | Attorney | Indefinite
from
March 8, 2007 |
| Siever, Beth F. | Austin, TX | Attorney | Indefinite
from
March 8, 2007 |
| Wheatley-Clark, Sheila R. | Houston, TX | CPA | Indefinite
from
March 8, 2007 |

Suspensions From Practice Before the Internal Revenue Service After Notice and an Opportunity for a Proceeding

Under Title 31, Code of Federal Regulations, Part 10, after notice and an opportunity for a proceeding before an ad-

ministrative law judge, the following individuals have been placed under suspension

from practice before the Internal Revenue Service:

| Name | Address | Designation | Effective Date |
|----------------|-------------|----------------|-------------------------------------|
| Redmond, Debra | Gifford, PA | Enrolled Agent | Indefinite
from
March 5, 2007 |

Disbarments From Practice Before the Internal Revenue Service After Notice and an Opportunity for a Proceeding

Under Title 31, Code of Federal Regulations, Part 10, after notice and an opportunity for a proceeding before an administrative law judge, the following individuals have been disbarred from practice before the Internal Revenue Service:

| Name | Address | Designation | Effective Date |
|------------------|-----------------------|-------------|-------------------|
| Brookstein, Gary | Huntingdon Valley, PA | CPA | December 15, 2006 |
| James T. Jubb | Baltimore, MD | CPA | December 15, 2006 |

Censure Issued by Consent

Under Title 31, Code of Federal Regulations, Part 10, in lieu of a proceeding being instituted or continued, an attorney, certified public accountant, enrolled agent, or enrolled actuary, may offer his or her consent to the issuance of a censure. Censure is a public reprimand. The following individuals have consented to the issuance of a Censure:

| Name | Address | Designation | Date of Censure |
|----------------------|-----------------|----------------|-------------------|
| Zucker, Robert W. | Boca Raton, FL | CPA | November 14, 2006 |
| Montgomery, David E. | Pleasanton, CA | Enrolled Agent | November 15, 2006 |
| Higgins, James M. | S. Boston, MA | Attorney | December 1, 2006 |
| Pennington, Debra L. | Lees Summit, MO | Enrolled Agent | January 29, 2007 |
| Goodwin, Steven C. | Concord, MA | Attorney | February 2, 2007 |
| Francis, Andrew W.E. | Houston, TX | CPA | February 21, 2007 |
| Griffin, Richard M. | Duluth, GA | CPA | February 28, 2007 |

Resignations of Enrolled Agents

Under Title 31, Code of Federal Regulations, Part 10, an enrolled agent, in order to avoid the institution or conclusion of a proceeding for his or her disbarment or suspension from practice before the Internal Revenue Service, may offer his or her resignation as an enrolled agent. The Director, Office of Professional Responsibility, in his discretion, may accept the offered resignation. The Director, Office of Professional Responsibility, has accepted offers of resignation as an enrolled agent from the following individuals:

| Name | Address | Date of Resignation |
|----------------------|-----------------|---------------------|
| Filipski, Kenneth M. | Bakersfield, CA | April 16, 2007 |

Archer Medical Savings Accounts — Cut-Off Year

Announcement 2007-44

PURPOSE

Sections 220(i) and (j) of the Internal Revenue Code provide that if the number of Archer Medical Savings Account (Archer MSA) returns filed for 2005 or 2006 or a statutorily specified projection of the number of Archer MSA returns that will be filed for 2005 or 2006 exceeds 750,000, then April 19, 2007, is a “cut-off” date for the Archer MSA pilot project. The Internal Revenue Service (IRS) has determined the following: (1) The applicable number of Archer MSA returns filed for 2004 is 39,037 and the applicable number of Archer MSA returns projected to be filed for 2005 is 35,246 (after reduction in each case for statutorily specified exclusions, such as the exclusion for previously uninsured taxpayers). Consequently, 2005 is not a “cut-off” year for the Archer MSA pilot project. (2) The applicable number of Archer MSA returns filed for 2005 is 16,850 and the applicable number of Archer MSA returns projected to be filed for 2006 is 15,192 (after reduction in each case for statutorily specified exclusions, such as the exclusion for previously uninsured taxpayers). Consequently, April 19, 2007 is not a “cut-off” date and 2006 is not a “cut-off” year for the Archer MSA pilot project.

BACKGROUND

The Health Insurance Portability and Accountability Act of 1996 added section 220 to the Code to permit eligible individuals to establish Archer MSAs under a pilot project effective January 1, 1997. The pilot project, as amended by The Tax Relief and Health Care Act of 2006 (TRHCA), Pub. Law. No. 109-432, § 117, has a scheduled “cut-off” year of 2006, but may have an earlier “cut-off” date if the number of individuals who have established Archer MSAs exceeds certain numerical limitations. Trustees’ reports for Archer MSAs established between (1) January 1, 2005 and June 30, 2005 and (2) January 1, 2006 and June 30, 2006, were due no later than March 20, 2007. IRS is required to publish a determination of whether 2005 or 2006 is a “cut-off” year no later than

April 19, 2007. See sections 220(i) and (j) as amended by TRHCA; Ann. 2007-24, 2007-10 I.R.B. 681.

If a year is a “cut-off” year, section 220 (i)(1) generally provides that no individual will be eligible for a deduction or exclusion for Archer MSA contributions for any taxable year beginning after the “cut-off” year unless the individual (A) was an active Archer MSA participant for any taxable year ending on or before the close of the “cut-off” year, or (B) first became an active Archer MSA participant for a taxable year ending after the “cut-off” year by reason of coverage under a high deductible health plan of an Archer MSA-participating employer.

Section 220(j)(2)(A) provides that the numerical limitation for 2005 is exceeded if the number of Archer MSA returns filed on or before April 15, 2005, for taxable years ending with or within the 2004 calendar year, plus the Secretary’s estimate of the number of Archer MSA returns for those taxable years which will be filed after April 15, 2005, exceeds 750,000.

Section 220(j)(2)(A) provides that the numerical limitation for 2006 is exceeded if the number of Archer MSA returns filed on or before April 15, 2006, for taxable years ending with or within the 2005 calendar year, plus the Secretary’s estimate of the number of Archer MSA returns for those taxable years which will be filed after April 15, 2006, exceeds 750,000.

For this purpose, section 220(j)(2)(A) provides that a tax return is an Archer MSA return for a taxable year if any exclusion is claimed under section 106(b) or any deduction is claimed under section 220 for that taxable year. Section 220(j)(2)(B) provides, as an alternative test, that: (1) the numerical limitation for 2005 is also exceeded if the sum of 90 percent of the Archer MSA returns for 2004 plus the product of 2.5 and the number of Archer MSAs for taxable years beginning in 2005 that are established during the portion of 2005 preceding July 1 (based on reports by Archer MSA trustees and custodians), exceeds 750,000 and (2) the numerical limitation for 2006 is also exceeded if the sum of 90 percent of the Archer MSA returns for 2005 plus the product of 2.5 and the number of Archer MSAs for taxable years beginning in 2006 that are established during the portion of 2006 preceding July 1 (based on reports

by Archer MSA trustees and custodians), exceeds 750,000.

Under section 220(j)(3), in determining whether any calendar year is a “cut-off” year, the Archer MSA of any previously uninsured individual is not taken into account. In addition, section 220(j)(4)(D) specifies that, to the extent practical, all Archer MSAs established by an individual are aggregated and two married individuals opening separate Archer MSAs are to be treated as having a single Archer MSA for purposes of determining the number of Archer MSAs.

2005 Not a Cut-Off Year

A total of 33,622 tax returns reporting an excludable or deductible contribution to an Archer MSA for the 2004 taxable year were filed by April 15, 2005. The number of taxpayers reported as being previously uninsured was not available. It has been estimated that an additional 5,415 tax returns reporting Archer MSA contributions for the 2005 taxable year have been or will be filed after April 15, 2005, including 0 taxpayers who were previously uninsured. Accordingly, it has been determined that there were 39,037 (33,622 plus 5,415) Archer MSA returns for 2005. As a result, 39,622 (39,622 minus 0) Archer MSA returns count toward the applicable statutory limitation for 2005 Archer MSA returns of 750,000.

Based on the Forms 8851 filed on or before March 20, 2007, by Archer MSA trustees and custodians, it has been determined that 45 taxpayers who did not have Archer MSA contributions for 2004 established Archer MSAs for 2005 during the portion of 2005 preceding July 1. Of this total, 0 taxpayers were reported by trustees and custodians as previously uninsured, and therefore are not taken into account in determining whether 2005 is a “cut-off” year. The alternative limitation for 2005 (90 percent of the applicable number of Archer MSA returns for 2004 plus the product of 2.5 and the number of applicable Archer MSAs established from January 1, 2005, through June 30, 2005) is 35,246 (90 percent of 39,037 plus 2.5 multiplied by 45), which is less than the statutory limit of 750,000. Thus, 2005 is not a “cut-off” year for the Archer MSA pilot project by reason of either the 2005 Archer MSA returns test of section 220(j)(2)(A) or

the alternative test of section 220(j)(2)(B) of the Code.

2006 Not a Cut-Off Year

A total of 17,306 tax returns reporting an excludable or deductible contribution to an Archer MSA for the 2005 taxable year were filed by April 15, 2006. Of this total, 3,038 taxpayers were reported as being previously uninsured. It has been estimated that an additional 3,055 tax returns reporting Archer MSA contributions for the 2005 taxable year have been or will be filed after April 15, 2006, including 473 taxpayers who were previously uninsured. Accordingly, it has been determined that there were 20,361 (17,306 plus 3,055) Archer MSA returns for 2006. Of this total, 3,511 (3,038 plus 473) were for taxpayers reported as being previously uninsured. As a result, 16,850 (20,361 minus 3,511) Archer MSA returns count toward the applicable statutory limitation for 2006 Archer MSA returns of 750,000.

Based on the Forms 8851 filed on or before March 20, 2007, by Archer MSA trustees and custodians, it has been determined that 11 taxpayers who did not have Archer MSA contributions for 2005 established Archer MSAs for 2006 during the portion of 2006 preceding July 1. Of this total, 0 taxpayers were reported by trustees and custodians as previously uninsured, and therefore are not taken into account in determining whether 2006 is a "cut-off" year. In addition, 0 taxpayers were reported by trustees and custodians as excludable from the count because his or her spouse also established an Archer MSA. Accordingly, the applicable number of Archer MSAs established from January 1, 2006, through June 30, 2006, is 11 (11

minus (0 plus 0)). The alternative limitation for 2006 (90 percent of the applicable number of Archer MSA returns for 2005 plus the product of 2.5 and the number of applicable Archer MSAs established from January 1, 2006, through June 30, 2006) is 15,192 (90 percent of 16,850 plus 2.5 multiplied by 11), which is less than the statutory limit of 750,000. Thus, 2006 is not a "cut-off" year for the Archer MSA pilot project by reason of either the 2006 Archer MSA returns test of section 220(j)(2)(A) or the alternative test of section 220(j)(2)(B) of the Code.

Questions regarding this announcement may be directed to Shoshanna Tanner in the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) at (202) 622-6080 (not a toll-free number).

Deletions From Cumulative List of Organizations Contributions to Which are Deductible Under Section 170 of the Code

Announcement 2007-46

The names of organizations that no longer qualify as organizations described in section 170(c)(2) of the Internal Revenue Code of 1986 are listed below.

Generally, the Service will not disallow deductions for contributions made to a listed organization on or before the date of announcement in the Internal Revenue Bulletin that an organization no longer qualifies. However, the Service is not precluded from disallowing a deduction for any contributions made after an or-

ganization ceases to qualify under section 170(c)(2) if the organization has not timely filed a suit for declaratory judgment under section 7428 and if the contributor (1) had knowledge of the revocation of the ruling or determination letter, (2) was aware that such revocation was imminent, or (3) was in part responsible for or was aware of the activities or omissions of the organization that brought about this revocation.

If on the other hand a suit for declaratory judgment has been timely filed, contributions from individuals and organizations described in section 170(c)(2) that are otherwise allowable will continue to be deductible. Protection under section 7428(c) would begin on May 7, 2007, and would end on the date the court first determines that the organization is not described in section 170(c)(2) as more particularly set forth in section 7428(c)(1). For individual contributors, the maximum deduction protected is \$1,000, with a husband and wife treated as one contributor. This benefit is not extended to any individual, in whole or in part, for the acts or omissions of the organization that were the basis for revocation.

World Project, Inc.
Brooklyn, NY
Izaak Walton League of America
Calumet Region Chapter
Dolton, IL
Greenbriar Club, Inc.
Clearwater, FL
Cunningham Family Foundation
West Jordan, UT
Roxbury Insurance Company
Los Angeles, CA
Wishes Are Forever Foundation
Salt Lake City, UT

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as “rulings”) that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A

and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance

of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.

ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel’s Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.

PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

Numerical Finding List¹

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