

## **A Question and Answer Guide to Internal Revenue Code Section 409A**

***Section 409A establishes requirements for nonqualified deferred compensation and imposes severe penalties on the beneficiaries of the arrangements that do not comply with these requirements.***

### **Question 1: What is the purpose of this guide?**

**Answer:** This guide provides, in question-and-answer format, a digest of the major features of Internal Revenue Code Section 409A that clients and nontax lawyers may need to know. (This guide has been updated as of October 2017 to reflect guidance issued to date.) Many qualifications, special rules and technicalities have been omitted in order to keep this guide readable; accordingly, an attorney who is expert in Section 409A matters should be consulted before documents are executed or actions are taken in reliance on anything contained herein.

### **SCOPE OF SECTION 409A**

### **Question 2: What does Section 409A apply to?**

**Answer:** Section 409A applies to “nonqualified deferred compensation,” which it defines very broadly. Basically, this means a present legally enforceable right to taxable compensation for services that will be paid in a later year. Section 409A can apply to nonqualified retirement plans, elective deferrals of compensation, severance and separation programs, post-employment payments provided for in an employment agreement, stock options, other equity incentive programs, reimbursement arrangements and a variety of other items. Below we explain which arrangements are affected by Section 409A and which may be exempt (see Question 4).

### **Question 3: Who is affected by Section 409A?**

**Answer:** Employees, independent contractors and directors who have entitlements to receive nonqualified deferred compensation are affected by Section 409A, and cash-basis entities that perform services can be affected.

The provision for the most part does not apply to compensation for services received by a cash-basis business with multiple customers, such as a professional firm, under the so-called “independent contractor” exemption, if the independent contractor provides “significant services” (as described below) to two or more unrelated service recipients during the independent contractor’s taxable year in which amounts are deferred. The various service

recipients must be unrelated to each other and to the independent contractor. The services provided cannot be management services or investment advisory services, and the exception is not available for corporate directors or persons in similar roles.

Under a safe harbor, an independent contractor is generally treated as providing “significant services” to more than one service recipient if not more than seventy percent of the total revenue of the independent contractor’s trade or business comes from any one service recipient.

**Question 4: What arrangements are exempt from Section 409A?**

**Answer:** The following are exempt from Section 409A:

- Tax-qualified retirement plans;
- Nontaxable benefits (such as agreements to reimburse health insurance premiums to the extent permitted under applicable law);
- Vacation, sick leave and disability pay;
- Incentive stock options (“ISOs”) and employee stock purchase (Section 423) plans;
- Nonqualified stock options with an exercise price for the shares at least equal to fair market value at the time of grant and that meet certain other requirements (all this is discussed at length below; see Questions 27-30);
- Nondeferred grants of equity (such as restricted stock or LLC interests), even if subject to vesting;
- Certain involuntary (which can also include a quit for “good reason”) severance programs in which payments are completed by the end of the second year following the year of severance, and only to the extent the payments do not exceed the lesser of a dollar limit, which is \$540,000 for the 2017 calendar year (\$550,000 for 2018), or twice the service provider’s recent annualized compensation amount;
- Certain broad-based plans maintained primarily for non-U.S. persons working abroad; and
- Short-term deferrals (see Question 5).

**Question 5: What is the short-term deferral exception?**

**Answer:** An important exception to Section 409A is for amounts that must be paid in full within two and one-half months after the later of the end of the service provider’s or of the service recipient’s tax year in which the right to the amount vests (becomes nonforfeitable).

Favorable Example: An employee has the right to receive \$100,000 if he is still employed when he reaches age sixty or, if earlier, within two and one-half months after the end of the year in which the company has a successful initial public offering. Even

though an IPO is not a permissible payment event (see Question 17), in this case the right to receive the compensation will only vest when the IPO occurs or the person attains age sixty while employed. The plan provides that in either case the amount will be paid promptly upon the event occurring, creating a short-term deferral to which Section 409A does not apply.

Unfavorable Example: An executive aged sixty in January 2017 is awarded a vested right to receive \$100,000 upon the earlier of separation from service or attainment of age sixty-five. Even if separation and payment occur in December 2017, this is not a short-term deferral because the amount could have been paid outside the short-term deferral period. (One implication is that the six-month wait described in Question 20 and applicable to certain employees of public companies may apply.)

### **EFFECTIVE DATES OF SECTION 409A RULES**

#### **Question 6: When did Section 409A become effective?**

**Answer:** For operational compliance, Section 409A became effective January 1, 2005. In fact, the effective date is more sweeping than it sounds, since the rules apply to any deferred compensation that either (a) vested (that is, became nonforfeitable) after December 31, 2004 or (b) is substantially modified after October 3, 2004. This means that numerous arrangements that may have been legally binding long before 2005 can be affected by Section 409A.

### **CONSEQUENCES OF VIOLATING SECTION 409A**

#### **Question 7: Who is penalized for violations of Section 409A?**

**Answer:** All of the tax penalties for Section 409A violations are imposed on the service provider (the employee or other worker). No penalties are imposed on the employer or other organization making the payments (the service recipient), although the payor will have reporting and (in the case of payments to employees) withholding obligations. Thus, while an employer who adopts a deferred compensation plan may seek legal advice concerning Section 409A compliance, getting things wrong will have the most drastic consequences not for the employer but for the employees who may have had no role in drafting the plan.

#### **Question 8: What is a Section 409A violation?**

**Answer:** Section 409A can be violated in one of two general ways. First, it will be violated if the applicable arrangement includes provisions that are inconsistent with the Section 409A rules; in other words, tax penalties can be imposed simply because documentation (be it a nonqualified deferred compensation plan, or an employment, severance or other applicable

service agreement) is not written correctly. Second, Section 409A penalties can be applied if an action is taken concerning the payment of deferred compensation that violates the Section 409A rules, even if such action is inconsistent with the terms of the relevant written document. Thus, Section 409A requires both “documentary” and “operational” compliance.

**Question 9: What are the consequences of a documentary or operational failure?**

**Answer:** In either case, a violation of Section 409A will result in substantial tax penalties for the affected service providers (employees or other workers). First, the nonqualified deferred compensation in question will be fully taxable as soon as the service provider has a vested (nonforfeitable) right to receive it, whether or not any payment is received. Second, a twenty percent additional tax penalty on the value of the nonqualified deferred compensation will be imposed at the same time. In addition, under certain circumstances, an interest charge will be imposed. For example, if a right to deferred compensation vests in 2016 and an operational failure occurs in 2018, an interest charge computed beginning in 2016 could be imposed.

We believe that the IRS is of the view that no tax statute of limitations begins to run until nonqualified deferred compensation has actually been paid out. Thus, if an operational failure occurs in 2011 (such as an untimely filed election to defer compensation) but is not detected on audit until 2018, at least so long as the deferred compensation has not yet been paid out, the IRS may assert that Section 409A penalties can be imposed. The IRS has issued some Revenue Procedures that prescribe requirements for correcting certain operational and documentary failures; where such circumstances exist and the Revenue Procedures are followed, the most severe Section 409A penalties can be avoided.

**Question 10: If an operational or documentary failure occurs, on which deferred compensation are the penalties imposed?**

**Answer:** Generally speaking, in the case of a documentary failure the penalties would be applied to all participants who are affected by the provision in question. If an operational failure occurs, only the service provider to whom the operational failure relates will be penalized. Once an operational violation occurs, however, penalties are imposed not only with respect to the item of deferred compensation that violated the rules, but also on all similar nonqualified deferred compensation rights. “Similar” means rights under deferred compensation plans of a like type. For this purpose, plans are divided into eight types: elective account balance plans, nonelective account balance plans, nonaccount balance (such as defined benefit) plans, separation pay plans, split-dollar insurance plans, in-kind benefit and reimbursement plans, stock rights and foreign plans. Thus, for example, if an operational violation occurs with respect to a service provider’s rights under a particular nonelective account balance plan, the penalties will be imposed on all nonelective account balance rights that the participant has with the same service recipient (employer), even if the other plans did not violate Section 409A. As a result of this sweeping aggregation rule, a Section 409A

operational violation that seems to affect only a small amount could produce enormous penalties for the service provider.

## **OVERVIEW OF MAJOR SECTION 409A REQUIREMENTS**

**Question 11: Does Section 409A regulate the types of deferred compensation benefits that may be provided and the persons who may receive them?**

**Answer:** No. Section 409A in no way restricts the size of deferred compensation benefits nor regulates the persons to whom they can be offered. Section 409A does not contain any nondiscrimination rules, participation or vesting standards. However, Section 409A in no way mitigates the applicability of other legal provisions that to some extent do regulate these matters, such as the golden parachute rules of Internal Revenue Code Section 280G (which can impose severe tax penalties on excessive payments in connection with a change in control) and the rules that exempt from certain parts of ERISA nonqualified retirement benefits to management and highly compensated employees.

**Question 12: What are the major restrictions that Section 409A imposes?**

**Answer:** The major restrictions are that: (a) deferred compensation may only be paid on the occurrence of an event specified when the deferred compensation is created, and only if the event is on the approved list contained in the statute; (b) deferred compensation payments may not be accelerated; (c) elections to defer compensation must be made irrevocably in the year before the services are performed to which the compensation relates (with some additional leeway for new plan participants and “performance-based” compensation); and (d) various techniques to secure the payment of nonqualified deferred compensation are not permitted. This guide will explain the first three of these requirements.

**Question 13: How do the restrictions on the timing of payment of deferred compensation work?**

**Answer:** Nonqualified deferred compensation may only be paid upon a service provider’s separation from service, disability or death, on a fixed payment date or pursuant to a fixed payment schedule, on a change in control of the business or on the occurrence of an unforeseeable emergency. A deferred compensation plan may provide for payment upon a single one of these events or a combination of them and must specify an objectively determinable date or year following a distribution event upon which the payment is to be made. (See Question 16.) Payment generally may not be made upon any of these events unless the plan initially specified such payment event as the trigger.

Generally, the regulations do not permit a designation of a different time and form of payment based on whether an event occurs. Exceptions to this general rule permit the designation of a different time and form of payment event based on whether the payment occurs before or after a single specified date and a limited ability to designate a different time

and form of payment depending on the conditions of a separation from service (such as one form of payment for a separation from service before a specified age and another form of benefit for separation from service after that age).

**Question 14: What happens if deferred compensation is not paid as scheduled?**

**Answer:** Failure to pay deferred compensation as provided in the applicable documents can be an operational violation triggering penalties. However, a payment will be treated as if it is paid on a designated date or payment event if it is paid by the later of: (a) the fifteenth day of the third month following the designated date or payment event; or (b) the last day of the calendar year containing the designated date or payment event. For example, if a plan calls for a payment of deferred compensation on June 1, 2017, no violation will occur if the compensation is paid by December 31, 2017. There are also rules permitting delays of payment in the case of unforeseeable administrative problems or if the payor is having financial difficulties, or if there is a legitimate dispute between the service provider and service recipient concerning the payment entitlement. Further, a plan may contain provisions permitting delays of payment where payment would jeopardize the employer's deduction under Internal Revenue Code Section 162(m) (concerning top executives of public companies), would violate a loan covenant or similar contractual obligation of the payor in a way that jeopardizes the payor's status as a going business or would violate federal securities or other applicable law.

**Question 15: What is a "separation from service?"**

**Answer:** It will not always be clear whether a separation from service has occurred. If a person ceases to be employed but continues to render services as a consultant or other independent contractor, a separation from service permitting payments to begin may not have occurred. The IRS is concerned both with the possibility that payments of deferred compensation due on separation will be delayed through "consulting" arrangements where few actual services are rendered and with the opposite possibility that employees may receive deferred compensation under the separation from service rubric while continuing to work intensively for the company after their formal employment has ended. The regulations presume that a separation has occurred if the employee's services decrease to twenty percent or less of their level over the preceding thirty-six months. If the services are at fifty percent or more of that level, the presumption is that no separation from service has occurred. In between, there is no presumption and a facts-and-circumstances analysis applies.

**Question 16: What are some examples of permissible payment provisions?**

**Answer:** Here are a few examples:

- (a) Payment will be made upon separation from service or, if earlier, attainment of age sixty-five.
- (b) Payment will be made upon the later of the participant's separation from service or attainment of age sixty-five.
- (c) Payment will be made in five equal annual installments beginning in 2017; and

(d) Payment will be made upon the earliest of the participant's separation from service or a change in control of the service recipient.

**Question 17: What are some examples of impermissible payment provisions?**

**Answer:** Section 409A prohibits many payment events that would otherwise make reasonable business sense. For example, each of the following is an impermissible payment provision.

(a) Payment of a vested fixed amount will be made in 2026 or, if earlier, when the company has a successful initial public offering. (An IPO generally is not a permissible payment event.)

(b) Payment will commence upon participant's attainment of age sixty-five; in the year he turns sixty-four, he may choose between a lump sum or ten substantially equal installments. (A choice of payment cannot be made at that time.)

(c) An existing plan that provides for payment on a date certain is amended to provide also for payment upon separation from service if earlier.

(d) Payment will be made upon a separation from service in a lump sum, but if separation is because of a voluntary resignation payment will be made in ten annual installments.

(e) A plan that provides for a lump sum payment at age sixty-five is amended after a participant reaches age sixty-four to provide instead for ten substantially equal annual installments.

**Question 18: What is the impact of the antiacceleration rule?**

**Answer:** Congress wanted to prohibit provisions that allowed participants to receive their deferred compensation prematurely by agreeing to take a "haircut," such as a ten percent or fifteen percent reduction in the amount. However, the rule also prohibits most payments of deferred compensation before the date specified in the plan document. Even an early payment within the same year the payment is due (unless no more than thirty days early) is a violation. The regulations do contain some important exceptions that, for example, would permit the early payment of deferred compensation upon the service recipient's (employer's) bankruptcy, sale or termination of the business, in connection with a court domestic relations order or to pay certain taxes. However, in order to take advantage of these provisions to pay deferred compensation earlier, it is necessary for the plan document to contain specific clauses so providing.

In addition, the regulations permit a discretionary termination and liquidation of a deferred compensation plan provided: (a) the termination is not related to a downturn in the financial health of the service recipient; (b) the service recipient terminates all other arrangements that would be aggregated with the terminating arrangement (see Question 10); (c) no payments in liquidation of the plan are made within twelve months of the termination (other than payments that would have occurred absent the termination may still be made); (d) all payments are made within twenty-four months of the termination; and (e) the service

recipient does not adopt a new plan of the same type within three years following the plan termination. The IRS has taken the position that it is not permissible to give a service provider discretion over whether to terminate an arrangement.

## **SPECIAL SITUATIONS**

### ***Public Company Employees***

#### **Question 19: Is there a special restriction for executives of public companies?**

**Answer:** Yes. Payment of nonqualified deferred compensation under the separation from service provision mentioned above may not be made to a “key employee” of a public company until six months have expired after separation from service. (See Question 20.)

#### **Question 20: How does the special restriction on certain public company employees work?**

**Answer:** “Key employees” of public companies may not receive payments of nonqualified deferred compensation on account of a separation from service during the first six months after the separation. (See Question 15 for a definition of separation from service.) Each public company (including non-U.S. public companies) is meant to compile an annual list of key employees, which means certain employees who are also owner-shareholders as well as the top group of officers. Persons on the list should be treated as key employees for Section 409A purposes beginning (in most cases) on April 1<sup>st</sup> of the year following the year in which first classified as a key employee and continuing for a twelve-month period.

This is a very significant issue for public company executives who otherwise would expect in many cases to receive monthly salary continuation or other deferred compensation payments beginning when their employment ceases. While it is perfectly permissible for an employer to hold back the payments that otherwise would be made during the first six months and to pay them in a lump sum (with or without interest) after the six months have expired, many executives are reluctant to bear the credit risk of such a program or, more simply, wish (or need) to receive the money earlier. One approach to accommodate that desire is to try to come within the short-term deferral and/or the separation pay plan exceptions. (See Questions 4 and 5.) There is no restriction on payments that are exempt from Section 409A from being made within the first six months (even though other amounts remain subject to the six-month delay).

It should also be noted that this rule does not prevent prompt payment of deferred compensation that is triggered for a reason other than separation from service. For example, if an executive who is a key employee has an entitlement to deferred compensation beginning at age sixty-five, the amounts may be paid at that time even if his retirement also happens to occur when he attains age sixty-five.



It is sometimes suggested that the six-month requirement can be avoided by making payments to a departing executive for “consulting services” even if no meaningful services may be rendered (for example where the executive is paid to be available to consult as requested). We are very concerned that if such payments are made within six months of separation the IRS will argue that they are, in effect, payments of deferred compensation subject to Section 409A penalties. (See Question 15, discussing further the possibility that purported consulting services can be recharacterized.)

### ***Elective Deferrals***

#### **Question 21: How does Section 409A affect elective deferrals?**

**Answer:** Many employers allow certain employees to elect to defer part of either their base salary or annual bonus, or both. In addition to the payment timing requirements that apply to all deferred compensation, Section 409A also has restrictions on the timing of such elections to defer compensation. The general rule is that such elections must be made irrevocably before the year in which the relevant services are performed. For example, if an employee wants to elect to defer ten percent of 2017 base salary or twenty percent of a 2017 annual bonus payable in 2018, an election to do so must be made no later than the end of December 2016.

However, elections to defer “performance-based compensation” may be made up to six months before the end of the “performance period.” This exception is not available for purely discretionary annual bonuses; the payment must be contingent upon the satisfaction of pre-established organizational or individual performance criteria specified in writing within ninety days after the service period begins and be substantially uncertain at the time of the participant’s deferral election. Where an employer adopts a specific program during the first ninety days of the year with clear guidelines for earning additional compensatory amounts, a decision to defer a portion of such payments could be made up to June 30 (in the case of a calendar year program), as long as there remains uncertainty about payment.

Also, when a person first becomes a participant in a deferred compensation program (including any similar deferred compensation programs – see Question 10) and has not previously participated in a similar program of the service recipient, he may file an election within the first thirty days of his participation, which will allow him to defer amounts earned after the election becomes irrevocable.

#### **Question 22: Once an elective deferral is made, can the service provider further defer the date for payment of the compensation?**

**Answer:** Yes, but only within strict limits. Any election to further defer the payment of compensation must be filed more than twelve months before the first payment of the deferred compensation becomes due, and must defer by at least five years the date for the commencement of the compensatory payments. Thus, an executive whose elective deferrals

come due for payment on January 1, 2018 could file an election up to December 31, 2016 to postpone the commencement date to January 1, 2023 or a later date.

### ***Nonelective Deferrals***

**Question 23:** Are there general guidelines for initial deferral elections under an arrangement that permits service recipient deferral elections but not service provider deferral elections?

**Answer:** An arrangement that does not permit deferral elections by the service provider must set the time and form of payments no later than the later of (a) the last date the service provider would have been permitted to make an election if the election was available to the service provider or (b) the date the service provider obtains a legally binding right to the compensation. Thus, although elective deferrals may only be made with respect to future services, an employer can institute a nonelective deferred compensation plan in recognition of past services.

### ***Foreign Situations***

**Question 24:** Does Section 409A apply to non-U.S. situations?

**Answer:** Unfortunately, yes. The regulations contain some exceptions for deferred-compensation entitlements under broad-based foreign plans, but one must assume that any person subject to United States taxation – a United States citizen, a “green-card” holder or any foreigner who comes to the United States to work – must consider Section 409A’s impact on any individually-negotiated deferred compensation rights and on any deferred compensation targeted at top executives. For example, a United States citizen who is an important executive of a French public company must consider the potential impact of the six-month rule described in Question 20 and must also consider whether stock options and stock appreciation rights to which he may be entitled create tax problems under Section 409A. (See Questions 27-30.)

In addition to Section 409A, certain foreign sponsors of deferred compensation arrangements may be subject to Internal Revenue Code Section 457A, which can impose additional limitations on these arrangements. For more information on Section 457A, please see our [advisory](#).

### ***Reimbursements and In-Kind Benefits***

**Question 25:** How does Section 409A apply to non-cash benefits and reimbursements?

**Answer:** Section 409A does not apply to benefits and reimbursements that are excluded from taxable income. For example, an employer’s reimbursement of an employee’s necessary business expenses or of an employee’s group health insurance premiums are (or can

be structured as) tax-free events and therefore Section 409A does not apply. On the other hand, Section 409A can apply to taxable reimbursements and to taxable fringe benefits. An exception, however, applies for taxable reimbursements made prior to the end of the year following the year in which the expense was incurred, provided that payments made in one taxable year do not affect payments made in any other taxable year, and other requirements are satisfied.

For example, it is common for executives to have rights under their employment contract to be reimbursed for a few thousand dollars of personal tax advice or financial planning advice incurred during the course of the contract. If an executive has a right to be reimbursed for up to \$5,000 of such expenses incurred in the course of a three-year employment agreement, Section 409A would be violated, since entitlement to the reimbursement extends over a three-year period, but the agreement does not provide a specific date for payment.

### ***Change in Control Situations***

#### **Question 26: How does Section 409A apply where a change in control occurs?**

**Answer:** Several Section 409A rules can come into play in this situation and need to be considered. As noted, a deferred compensation arrangement can specifically provide that payments will be made upon a change in control, but such provisions must be included in the arrangement at the outset, not inserted on the eve of the change in control. (Not surprisingly, Section 409A has a complicated “change in control” definition.) Many times the change in control is accompanied by agreements that give top executives rights to receive payments over a substantial period of time if they are dismissed or quit for “good reason” after the change in control. Where the executive was a key employee of a public company, in many instances such payments may not begin until six months have expired after the end of employment. (See Question 20.) As noted above, in such instances some or all of these payments may be structured to qualify under the short-term deferral and/or the separation pay exceptions. (See Questions 4 and 5.) Consideration also has to be given to the possible impact of the golden parachute rules of Code Section 280G.

In addition, certain transaction-based compensation paid on certain types of changes in control may be delayed so that the service provider is paid at the same time as other owners of the business (for example, under a so-called “earnout” provision or in the event amounts are held in escrow). Although a delay in payment beyond the date of the change of control is generally not permitted under Section 409A, the IRS has granted relief under certain narrow circumstances, generally requiring that the payment be made at the same time and in the same form as other owners are paid and in all events within five years of the change in control.

## ***Severance Pay***

### **Question 27: How does Section 409A impact severance pay?**

**Answer:** Severance arrangements can avoid Section 409A entirely by qualifying as a “short-term deferral” (see Question 5) or under the “severance pay” exception (see Question 4). The exceptions may be “stacked” so that amounts that do not qualify as short-term deferrals may be exempt under the severance pay exception. Amounts that are not exempt under these exceptions must comply with Section 409A. This includes potential application of the six month wait (see Questions 19-20) and limits on the ability to modify an existing severance deal (negotiated at hire, for example) on the eve of termination. Accordingly, careful structuring is critical, as discussed further in our [advisory](#), and must be approached with care.

## ***Stock Options and Stock Appreciation Rights***

### **Question 28: How are stock options and stock appreciation rights affected by Section 409A?**

**Answer:** Options that qualify as incentive stock options (“ISOs”) are exempt from Section 409A. So are options created under Internal Revenue Code Section 423 employee stock purchase plans. Other (nonqualified) stock options must comply with various rules in order to avoid Section 409A penalties. Similar rules apply to stock appreciation (or share appreciation) rights (“SARs”).

### **Question 29: What are the major rules concerning nonqualified stock options and SARs?**

**Answer:** These equity rights will generally violate Section 409A and trigger penalties unless:

- (a) The option exercise price (or SAR base value) is at least equal to the stock’s fair market value at the time of grant;
  - (b) The option or SAR pertains to common stock of the entity the optionee works for or a parent of such entity and, in general, the stock does not have any preference as to distributions and is not subject to a mandatory repurchase obligation or a put or call right, except in certain situations; and
  - (c) The option or SAR does not contain any additional deferral rights.
- Similar rules apply to equity rights in non-corporate entities.

If the tests above are met, the equity right is exempt from Section 409A. Alternatively, an option could be subject to Section 409A but compliant if (for example) it may be exercised only upon the first to occur of a change in control, separation from service or a specified date. These requirements are explained further below.

**Question 30: How can one be sure that the exercise price or base value of a stock option or SAR meets the fair market value requirement?**

**Answer:** This is a difficult problem for private company issuers. The regulations offer certain presumptive safe harbors. These include obtaining an independent appraisal as of a date within twelve months before the grant of the option or SAR, the use of a formula that is consistently applied to both compensatory and noncompensatory transactions in the issuer's shares and, in the case of illiquid companies during their first ten years, the use of a reasoned written report delivered by a knowledgeable person. For various reasons, we find that some of our private-company clients, in particular our non-U.S. private company clients, are unable (or unwilling) to utilize any of these safe harbors, generating a tax risk for the very individuals to whom they are trying to provide incentives. Under these circumstances, it may be appropriate to consider structuring the option (or SAR) in a Section 409A compliant manner, even if that limits flexibility with respect to exercise.

**Question 31: What is meant by additional deferral features?**

**Answer:** The rules abolish programs under which an executive can exchange in-the-money stock options for a deferred compensation account. In addition to the prohibition on additional deferral features, it should be noted that any meaningful amendment of an existing stock option (including an ISO) may require the option to be repriced to current value to avoid Section 409A penalties. However, the final regulations do permit options to be modified to extend the exercise period within certain limits – for example, it may be possible to extend the exercise period of an option scheduled to expire shortly after employment terminates until the normal exercise period ends in connection with a negotiated severance.

**Question 32: Can phantom stock plans still be used?**

**Answer:** It depends. Generally speaking, a phantom plan that allows the holder to turn in his units at a time of his choosing would violate Section 409A. However, it is still possible to construct phantom stock and similar plans that have payment dates only as permitted under Section 409A, such as a phantom stock program where the units will be redeemed upon the earlier of separation from service or a specified date.

**Question 33: How does Section 409A affect the thinking about other equity compensation programs?**

**Answer:** We believe that Section 409A makes direct grants of restricted stock (stock subject to vesting) and of LLC and partnership capital or profits interests more attractive; the simple reason is that such direct equity grants are not subject to Section 409A. It should be possible, for example, to build into a grant of profits interests in an LLC features that would not be permissible were the holder instead to receive a stock option or SAR-type right. We also have seen an increased interest in restricted stock unit ("RSU") programs under which stock will be transferred at a specified future date (with delivery upon vesting and thus exempt under the

short-term deferral exception) if the service provider remains employed. However, because the regulations give the IRS sweeping anti-abuse powers, not every purported direct equity grant will necessarily be respected as Section 409A-exempt.

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**If you have any questions concerning Section 409A, please do not hesitate to contact a member of the Benefits Practice Group.**

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