

May 1, 2007

SUMMARY OF FINAL TREASURY REGULATIONS FOR §409A*CLARK CONSULTING'S IN-DEPTH ANALYSIS*

On April 10, 2007, the Treasury Department and the IRS issued the final regulations for implementing the requirements of Internal Revenue Code §409A (“§409A”) that apply to nonqualified deferred compensation arrangements. The final regulations, which are generally applicable for taxable years beginning on or after January 1, 2008, incorporate many of the rules contained in the proposed regulations and provide additional guidance and clarification necessary for plan sponsors to bring their arrangements into compliance with the requirements of §409A by December 31, 2007.

Highlights of Final Regulations

- ◆ **Documentary Compliance NOT Extended.** Plan sponsors have until December 31, 2007 to bring their plan documents into compliance with the requirements of §409A and the regulations. In order to satisfy this requirement, the regulations provide guidance on several key issues, including the material terms that must be set forth in writing in the plan document.
- ◆ **Transition Relief for Distribution Elections Available Until December 31, 2007.** Plan sponsors have until December 31, 2007 to solicit new distribution elections for amounts subject to §409A in accordance with the transition relief provided in Notice 2006-79.
- ◆ **Additional Guidance on Applying the Timing Rules for Deferral Elections.** The regulations generally incorporate the timing rules for deferral elections contained in the proposed regulations, but also provide additional guidance on the application of these rules. For example, the regulations describe the circumstances under which a former plan participant (e.g., a re-hire) may be treated as “newly eligible” under a plan and therefore be permitted to submit a deferral election within 30 days of “initial” eligibility for compensation not yet earned.
- ◆ **Additional Guidance Regarding Identification of “Key Employees.”** The regulations provide additional guidance for determining whether a participant is a “key employee” and therefore must be subject to a 6-month delay in payments triggered by a separation from service. For example, the regulations provide guidance regarding the identification of “key employees” after certain corporate transactions (e.g., a merger of two public companies). The regulations also provide flexibility for plan sponsors to use certain alternative methods for applying the 6-month delay requirement in compliance with §409A.
- ◆ **Guidance Regarding When a Change from One Form of “Life Annuity” to Another is Exempt from the Application of the “Subsequent Change Rules.”** The proposed regulations provided that a change between actuarially equivalent forms of life annuities will not be treated as a change in the form or time of payment for purposes of §409A — i.e., the “subsequent change rules” do not apply. For purposes of applying this rule, the final regulations define the term “life annuity” and provide guidance to determine whether two forms of life annuities are considered actuarially equivalent.
- ◆ **Guidance on Equity and Other Arrangements.** The regulations provide additional guidance and clarification regarding the application of §409A to many other types of arrangements, such as equity (e.g., stock options, SARs) and severance/separation pay.

A more extensive summary of the final regulations prepared by Clark Consulting's Technical Resource Group is included on the following pages.

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I. EFFECTIVE DATE OF THE REGULATIONS AND GUIDANCE REGARDING DOCUMENTARY COMPLIANCE

Effective Date of the Regulations

The regulations are generally applicable for taxable years beginning on or after January 1, 2008. Therefore, plan sponsors have until December 31, 2007 to bring their nonqualified deferred compensation plans into documentary and operational compliance with the regulations. In the interim, plan sponsors may continue to operate plans in good faith compliance with the proposed regulations, or may choose to rely on the final regulations.

The regulations also provide that the transition relief contained in Notice 2006-79 continues to apply during 2007. As a result, plan sponsors have until December 31, 2007 to allow participants to make new distribution elections for amounts subject to §409A. Note, however, that this transition relief for distribution elections cannot be utilized during 2007 with respect to amounts payable in 2007 or amounts that would become payable in 2007 as a result of a new distribution election.

Documentary Compliance

In order to comply with §409A, the regulations require that the plan be established and maintained in accordance with the requirements of §409A. As part of this requirement, the material terms of the plan must be set forth in writing. The table below summarizes the requirements provided in the regulations that must be satisfied for a plan document to be in compliance with §409A.

DOCUMENTARY COMPLIANCE

Issue	Provisions in the Regulations
<p>Plan Must be “Established”</p>	<p>In order to comply with §409A, the regulations require that the plan be “established” and maintained in accordance with the requirements of §409A and the regulations. The regulations provide guidance for determining when a plan is considered “established,” including:</p> <ul style="list-style-type: none"> ◆ When a Plan is Considered to be “Established.” In general, a plan is considered to be “established” on the <u>latest of</u>: (i) the date on which it is adopted, (ii) the date on which it is effective, and (iii) the date on which the material terms are set forth in writing. ◆ Transition Rule for Unwritten Plans Adopted and Effective Before December 31, 2007. The regulations provide that a legally enforceable, unwritten plan that was adopted and effective before December 31, 2007, will be treated as “established” as of the <u>later of</u> the date on which it is adopted or becomes effective, provided that the material terms are set forth in writing <u>on or before December 31, 2007</u>.
<p>Written Plan Requirement</p>	<p>As noted above, the material terms of the plan must be set forth in writing. Additional guidance on this requirement is described below.</p> <ul style="list-style-type: none"> ◆ The Terms of the Plan May be Set Forth in One or More Documents. The regulations clarify that for purposes of the rules regarding documentary compliance, the “plan” consists of all documents that together define a participant’s rights to the deferred compensation including, for example, a deferral election form.

DOCUMENTARY COMPLIANCE (CONT.)

Issue	Provisions in the Regulations
<p>Written Plan Requirement (Cont.)</p>	<p>◆ Examples of Material Terms that Must be Included in the Plan Document. Examples provided in the regulations of material terms that must be set forth in writing in the plan document include:</p> <ul style="list-style-type: none"> • The conditions under which an initial election to defer compensation under the plan may be made; • The amount (or method/formula for determining the amount) of deferred compensation to be provided under the plan; • The events or specified time upon which amounts deferred under the plan will be distributed, and the payment schedule (i.e., form and/or time of payment) for such amounts; • The conditions under which a subsequent change may be made to the form and/or time of payments; and • The requirement to impose a 6-month delay in payments triggered by the separation of service of a “key employee” (as determined in accordance with the regulations). <p>◆ Certain Terms Related to Operation of the Plan are Not Required to be in Writing. Certain provisions related to the operation of the plan are not required to be in writing, including:</p> <ul style="list-style-type: none"> • Any actions taken or amendments made to a plan prior to January 1, 2008, provided such actions were based on a good faith interpretation of applicable transition guidance and do not affect the plan’s compliance with §409A and the regulations for periods after January 1, 2008 (e.g., the transition relief provided in Notice 2005-1 by which participants were able to cancel participation in a nonqualified plan during 2005 with respect to amounts subject to §409A); and • Certain exceptions to the “anti-acceleration rule” provided in the regulations, pursuant to which a plan sponsor may accelerate the time or schedule for paying benefits without being treated as a change to the time or form of payment under §409A (e.g., payments made pursuant to a domestic relations order). <p><i>Clark Consulting Note:</i> The waiver of a written requirement for the actions described above does not alleviate a plan sponsor’s burden to demonstrate that the plan has been operated in compliance with applicable transition guidance and/or provisions in the regulations.</p> <p>◆ A “Savings Clause” Does Not Ensure Documentary Compliance. The regulations clarify that a “savings clause” (i.e., a provision that provides that the plan will be interpreted in a manner consistent with the requirements of §409A and any noncompliant provisions will have no effect) is <u>not</u> sufficient to prevent a violation of §409A under circumstances where the plan document either (i) contains terms that do not meet the requirements of §409A and the regulations, or (ii) fails to contain a material term necessary to meet the requirements of §409A and the regulations.</p> <p><i>Clark Consulting Note:</i> Because plan sponsors cannot rely on a “savings clause,” they must review all documentation for arrangements subject to §409A and amend the documents as necessary to ensure that the plan terms comply with the requirements of §409A and the final regulations.</p>

II. DEFERRAL ELECTIONS

Overview

§409A generally requires deferral elections to be submitted before the end of the participant’s taxable year (i.e., 12/31) preceding the service period, subject to limited exceptions provided in the regulations. Exceptions to this general rule include elections to defer “performance-based compensation” (as defined in the regulations) and deferral elections made during the first year in which an individual is eligible to participate in the plan. This section summarizes the guidance in the regulations pertaining to the required timing of deferral elections, as well as other key requirements under the regulations for a deferral election to be made in compliance with §409A.

General Timing Rule for Deferral Elections

As noted above, §409A generally requires deferral elections to be submitted before the end of the participant’s taxable year (i.e., 12/31) preceding the service period – commonly referred to as the “general timing rule.” By way of example, applying the general timing rule to base salary earned in 2009 and bonus compensation earned in 2009 (payable in 2010), a deferral election must be submitted no later than December 31, 2008. The regulations provide limited exceptions to the general timing rule, which are described below.

Elections to Defer “Performance-Based Compensation”

Under §409A, plan sponsors generally may permit participants to make a new deferral election for amounts that qualify as “performance-based compensation” (as defined in the regulations), provided that the election is made no later than six months before the end of the performance period. The table below summarizes the guidance provided in the regulations related to the deferral of “performance-based compensation.”

ELECTIONS TO DEFER “PERFORMANCE-BASED COMPENSATION”

Issue	Provisions in the Regulations
<p>Definition of “Performance-Based Compensation”</p>	<p>Definition of “Performance-Based Compensation.” The regulations define “performance-based compensation” as compensation where the amount of, or entitlement to, such compensation is contingent on the satisfaction of “pre-established” organizational or individual performance criteria relating to a performance period of <u>at least 12 consecutive months</u>.</p> <p>Examples of Amounts that will Not Qualify as “Performance-Based Compensation.” Examples of amounts that will <u>not</u> qualify as “performance-based compensation” under §409A include:</p> <ul style="list-style-type: none"> • Amounts based on a performance period of <u>less than</u> 12 consecutive months (e.g., a monthly or quarterly bonus); • Amounts paid <u>regardless of</u> performance (e.g., a discretionary bonus amount or a guaranteed bonus amount); and • Amounts based upon a level of performance that is <u>substantially certain to be met</u> at the time the performance criteria are established.

ELECTIONS TO DEFER “PERFORMANCE-BASED COMPENSATION” (CONT.)

Issue	Provisions in the Regulations
<p>Pre-Established Performance Criteria</p>	<p>Determining Whether Performance Criteria May be Considered “Pre-established.” The regulations clarify that performance criteria will only be considered “pre-established” if (i) the criteria are established <u>in writing no later than 90 days</u> after the commencement of the performance period to which the criteria relates, and (ii) the outcome is “substantially uncertain” at the time criteria are established. It is <u>not</u> required that the performance criteria be approved by a compensation committee of the board of directors or by the shareholders in order for an amount paid pursuant to such criteria to qualify as “performance-based compensation” under §409A.</p> <p>Amounts May be Based Upon Subjective Performance Criteria in Limited Circumstances. The regulations provide that “performance-based compensation” may generally include amounts based upon subjective performance criteria, <u>provided that</u> the subjective performance criteria are bona fide and relate to the performance of the participant, a group that includes the participant, or a business unit to which the participant provides services. However, this rule is subject to certain limitations. For example, the determination of whether or not the subjective performance criteria have been met cannot be made by the participant or a person who is under the supervision of the participant.</p>
<p>Segregation of “Performance-Based” Amounts from Non-Performance-Based Amounts</p>	<p>The regulations clarify that a portion of an award that would qualify as “performance-based compensation” is <u>not</u> disqualified from being treated as “performance-based compensation” under §409A <i>merely</i> because some portion of the award will be paid regardless of performance, <u>provided that</u> (i) the portion that would qualify as “performance-based compensation” is designated separately or otherwise separately identifiable under the terms of the arrangement from the non-performance-based portion of the bonus/incentive, and (ii) the amount of bonus/incentive that would qualify as “performance-based compensation” is determined independently from the non-performance-based portion of the bonus/incentive.</p>
<p>Equity Compensation May Qualify as “Performance-Based Compensation”</p>	<p>The regulations provide that compensation may qualify as “performance-based compensation” where the right to receive such compensation is based <u>solely</u> on an increase in the value of the employer, or a share of the employer’s stock, 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 <u>only</u> to the extent that the value of such shares appreciates or depreciates (e.g., a grant of a fixed number of restricted stock units with time-based vesting), generally will <u>not</u> qualify as “performance-based compensation. The regulations also provide that an award of equity-based compensation may constitute “performance-based compensation” if the right to receive the compensation is subject to a condition that would otherwise qualify as “performance-based compensation,” such as a performance-based vesting condition.</p>

ELECTIONS TO DEFER “PERFORMANCE-BASED COMPENSATION” (CONT.)

Issue	Provisions in the Regulations
<p>Deadline for Elections to Defer “Performance-Based Compensation” and Limitations on this Special Timing Rule</p>	<p>With respect to amounts that qualify as “performance-based compensation” (as defined in the regulations), the regulations provide a special timing rule under which a deferral election may be made on or before the date that is <u>six months before the end of the performance period</u>, subject to the following limitations:</p> <ul style="list-style-type: none"> ◆ The Election Cannot Apply to Amounts that are “Readily Ascertainable.” An election to defer an amount that qualifies as “performance-based compensation” cannot be made after such amount has become “readily ascertainable” (as described below); and ◆ Minimum Period of Service Required. In order for a participant to be eligible to make an election pursuant to the special timing rule for “performance-based compensation,” the participant must have performed services continuously from the beginning of the performance period (or, if later, the date on which the performance criteria are established) through the date upon which the deferral election may be made.
<p>When Amounts are Considered to be “Readily Ascertainable”</p>	<p>As noted above, the regulations provide that an election to defer “performance-based compensation” cannot apply to any portion of such compensation that has become “readily ascertainable.” The regulations provide the following guidance related to this limitation:</p> <ul style="list-style-type: none"> ◆ Determining Whether Amounts are “Readily Ascertainable.” For purposes of determining whether an amount of “performance-based compensation” has become “readily ascertainable” and therefore cannot be deferred under the special timing rule, the regulations provide the following guidance: <ul style="list-style-type: none"> • If the compensation is a specified or calculable amount, it is considered “readily ascertainable” when the amount is substantially certain to be paid; and • If the compensation is <u>not</u> a specified or calculable amount (e.g., where the amount may vary based upon the level of performance), it is not considered to be “readily ascertainable” until such compensation is both calculable and substantially certain to be paid. ◆ “Bifurcation” between Amounts that are “Readily Ascertainable” and Amounts that are Not. The regulations provide that where only a portion of “performance-based compensation” has become “readily ascertainable,” the compensation shall be <u>bifurcated</u> between the portion that has become “readily ascertainable” and the portion of compensation that has not. This “bifurcation” process preserves the ability to apply a participant’s deferral election to the portion of such “performance-based compensation” that has <u>not</u> become “readily ascertainable.”

Deferral Elections Made by “Newly Eligible” Participants

During the first year in which an individual is eligible to participate in a plan, a deferral election can be made within 30 days of eligibility, but only as to services performed subsequent to the election. The regulations provide guidance regarding the application of this timing rule for deferral elections, as summarized in the table below.

DEFERRAL ELECTION RULE FOR “NEWLY ELIGIBLE” PARTICIPANTS

Issue	Provisions in the Regulations
<p>“Plan Aggregation Rules” Apply</p>	<p>The regulations provide that the “plan aggregation rules” apply in determining whether a participant is “newly eligible” for a “plan.” This means, for example, that an employee who is eligible to participate in an “elective account balance” plan (e.g., a voluntary deferred compensation plan) sponsored by the employer generally cannot subsequently be treated as a “newly eligible” participant in any other “elective account balance” plans sponsored by that employer. <i>Note that the “plan aggregation rules” are discussed more fully in Part V of this bulletin.</i></p>
<p>Determining When a Participant is Considered “Newly Eligible” for a Plan</p>	<p>Definition of “Eligible.” The regulations provide that an individual is deemed to be “eligible” to participate in a plan when, pursuant to the terms of the plan, the individual is eligible to accrue an amount of deferred compensation under the plan (excluding earnings on previously deferred amounts), <u>even if</u> the individual has elected not to accrue an amount of deferred compensation in the plan.</p> <p>A Former Plan Participant May be Treated as “Newly Eligible” in Limited Circumstances. The regulations clarify that an individual who has previously participated in a plan (e.g., a former employee who is re-hired) may be treated as “newly eligible” under the limited circumstances summarized below.</p> <ul style="list-style-type: none"> • <u>Following the Complete Distribution of Previously Deferred Amounts if the Individual Was Not Eligible to Continue in the Plan When Final Payment Was Made.</u> If an individual (i) has been paid <u>all</u> amounts deferred under a “plan” (determined in accordance with the “plan aggregation rules”), and (ii) as of the date of the last benefit payment was <u>not</u> eligible to continue (or not eligible to elect to continue) to participate in the plan for periods following the last such payment, the individual may be treated as a “newly eligible” participant. This rule may apply, for example, to a former plan participant who received his or her entire account balance in a lump sum payment upon separation from service and is subsequently re-hired by the employer; or • <u>Where the Individual has Not Been Eligible to Participate in the Plan for a Period of at Least 24 Months.</u> If an individual has not been “eligible” to participate in a “plan” (determined in accordance with the “plan aggregation rules”) for a period of <u>at least 24 months</u>, that individual may be treated as a “newly eligible” participant. In contrast to the rule above, this rule may be applied to a participant who has not received a complete distribution from the plan (e.g., such as a former employee whose account is being distributed over a period of time and is subsequently re-hired during the benefit payout period).
<p>Method for Calculating the Amount Deferred for Certain Compensation</p>	<p>An election made pursuant to the timing rule for deferrals by a “newly eligible” participant may only apply to compensation attributable to <u>services performed subsequent to the election</u>. The regulations provide that where the compensation subject to such a deferral election is earned based on a specified performance period (e.g., an annual bonus), the deferral election will be deemed to apply only to compensation attributable to services performed subsequent to the election if such deferral amount is equal to <u>no more than</u> the total amount of compensation for the performance period, multiplied by a ratio, the numerator of which is the number of days remaining in the service period after the deferral election was made and the denominator of which is the total number of days in the service period.</p>

Other Exceptions to the General Timing Rule for Deferral Elections

The table below describes some of the other exceptions to the general timing rule for deferral elections that are addressed in the regulations.

OTHER EXCEPTIONS TO THE GENERAL TIMING RULE FOR DEFERRAL ELECTIONS

Issue	Provisions in the Regulations
<p>Elections to Defer Compensation that is Subject to Risk of Forfeiture (“Ad Hoc Awards”)</p>	<p>Timing Rule for Elections to Defer “Ad Hoc Awards.” The regulations provide that an election to defer compensation that qualifies as an “ad hoc award” (as described below) may be made at any time on or before the end of the 30-day period following the date the participant obtains a legally binding right to such compensation, provided the election is made <u>no later than</u> 12 months prior to the earliest date on which the forfeiture condition could lapse.</p> <p>Determination of Whether Compensation May be Treated as an “Ad Hoc Award.” Under the regulations, an “ad hoc award” generally includes any compensation (i) to which a participant has a legally binding right to payment in a subsequent year, and (ii) that is subject to a forfeiture condition (i.e., vesting) requiring the participant’s <u>continued services for a period of at least 12 months</u> from the date the participant obtains the legally binding right.</p> <p>Treatment of Compensation that is Subject to a Potential Acceleration of Vesting Before the End of the Required Service Period. The regulations clarify that compensation is <u>not</u> disqualified from being treated as an “ad hoc award” <i>merely</i> because the forfeiture condition <u>could</u> lapse prior to the end of the required 12-month minimum service period due to death, disability (as defined in the regulations) or the occurrence of a “change in control event” (as defined in the regulations). However, if the forfeiture condition <u>actually</u> does lapse prior to the end of the 12-month minimum service period (even if triggered by death, disability or the occurrence of a “change in control event”), the compensation <u>cannot</u> be treated as an “ad hoc award” for purposes of the deferral election timing rule described above.</p> <p>Example: On March 1, 2008, an employee is granted a \$10,000 retention bonus that will become vested on April 1, 2009, but only if the participant continues to provide services for the employer through April 1, 2009. The compensation may be treated as an “ad hoc award” and the employee may be permitted to make a deferral election for the compensation, provided that the deferral election is submitted no later than March 31, 2008 (i.e., no later than 30 days after the employee obtains a legally binding right to the compensation, and at least 12 months prior to the earliest date on which the forfeiture condition could lapse).</p>

OTHER EXCEPTIONS TO THE GENERAL TIMING RULE FOR DEFERRAL ELECTIONS (CONT.)

Issue	Provisions in the Regulations
<p>Elections to Defer “Fiscal Year Compensation”</p>	<p>Timing Rule for Elections to Defer “Fiscal Year Compensation.” If the fiscal year of the employer differs from the taxable year of the participant, the regulations provide a coordination rule that allows a participant to make an election to defer any “fiscal year compensation” (as defined in the regulations) by submitting a deferral election no later the last day of the employer’s fiscal year preceding the fiscal year in which such compensation will be earned.</p> <p>Definition of “Fiscal Year Compensation.” The regulations define the term “fiscal year compensation” as compensation earned over one or more consecutive fiscal years of the employer that is <u>not</u> payable during such fiscal year service period. The regulations indicate that certain amounts generally will <u>not</u> qualify as “fiscal year compensation,” including base salary payable during the employer’s fiscal year.</p> <p>Example: An employer has a tax year ending September 30th. Under the employer’s annual bonus plan, participants are entitled to receive a guaranteed annual bonus related to services performed during the employer’s fiscal year beginning October 1, 2010 and ending September 30, 2011, which will become payable in December 2011. Because the bonus would qualify as “fiscal year compensation,” a deferral election for such compensation may be made on or before September 30, 2010.</p>

Additional Guidance for a Deferral Election to be Made in Compliance with §409A

The regulations provide additional guidance related to the requirements for a deferral election to be made in compliance with §409A, as summarized in the table below.

ADDITIONAL GUIDANCE FOR DEFERRAL ELECTIONS

Issue	Provisions in the Regulations
<p>Deferral Elections Must Be Irrevocable</p>	<p>A deferral election is not considered to be made for purposes of §409A until the election becomes irrevocable under the terms of the arrangement. The regulations provide that a plan may allow a deferral election to be changed, provided that any change is made no later than the required deadline for making such deferral election under the regulations and the election becomes irrevocable by such deadline.</p>
<p>“Evergreen” Elections are Permitted</p>	<p>A plan may allow “evergreen elections” (i.e., deferral elections that remain in effect until changed or revoked), provided that the election (or change to such election) becomes irrevocable no later than the required deadline for making such deferral election under the regulations.</p> <p>Example: A plan may permit an “evergreen” election to defer salary earned in 2008, provided that the election or change to such election becomes irrevocable no later than December 31, 2007.</p>

ADDITIONAL GUIDANCE FOR DEFERRAL ELECTIONS (CONT.)

Issue	Provisions in the Regulations
<p>Commissions – Rules to Determine When the Service Period Begins</p>	<p>The regulations provide guidance for determining when the service period for commission compensation is considered to begin and therefore when a deferral election for such compensation must be made. Under this guidance, the regulations distinguish between “sales commission compensation” (as defined in the regulations) and “investment commission compensation” (as defined in the regulations), summarized as follows:</p> <ul style="list-style-type: none"> ◆ Service Period for “Sales Commission Compensation.” The regulations provide that with respect to “sales commission compensation” (as defined in the regulations), a participant is generally treated as having performed services <u>only</u> in either (i) the participant’s taxable year in which the unrelated customer remits payment (upon which the commission is derived) to the company, or (ii) if applied consistently to all similarly situated participants, the participant’s taxable year in which the sale occurs. This means, for example, that a deferral election for “sales commission compensation” will be deemed to have been made in compliance with the requirements of §409A if the election is made no later than the December 31st preceding the taxable year in which the unrelated customer remits payment to the company. ◆ Service Period for “Investment Commission Compensation.” With respect to “investment commission compensation” (as defined in the regulations), the regulations provide that a participant is generally treated as having performed services during the 12-month period immediately <u>preceding</u> the date on which the overall value of the assets or asset accounts is determined for purposes of calculating such “investment commission compensation.”
<p>Compensation Earned During Final Payroll Period</p>	<p>Unless otherwise provided in the plan, compensation that is both (i) attributable <u>solely</u> to services performed during the final payroll period containing the last day of the participant’s taxable year, and (ii) payable in the subsequent taxable year, will be treated as compensation earned <u>in that subsequent taxable year</u> for purposes of applying the deferral election timing rules of §409A.</p> <p>Example: An employer pays salary to its employees on a bi-weekly basis and the final payroll period for the year runs from December 21, 2008 through January 3, 2009, with a scheduled payment date of January 9, 2009. Under the rule described above, a participant will be deemed to have provided services during calendar year 2009 with respect to the salary payable for that final payroll period (unless the employer’s arrangement provides for an alternate treatment for such compensation). As a result, the employer would apply the participant’s deferral election for salary earned in 2009 (submitted at the end of 2008) to <u>all</u> salary payable for such final payroll period.</p> <p><i>Clark Consulting Note:</i> Without the availability of this rule the employer in the example above would be required to “bifurcate” the final payroll and (i) apply the deferral election, if any, that was made in 2007 to the portion of salary earned at the end of 2008, and (ii) apply the deferral election that was made in 2008 to the portion of salary earned in 2009.</p>

III. DISTRIBUTION ELECTIONS

Overview

The regulations provide guidance regarding (i) the deadline by which the form and/or timing of benefit payments under a nonqualified deferred compensation plan must initially be elected by the participant or designated by the plan sponsor, and (ii) the application of the rules of §409A regarding any subsequent changes in the form or timing of payment.

Initial Distribution Elections

Elective Arrangements. If a plan allows participants to elect the form and/or timing of payment with respect to amounts deferred under the arrangement, the initial payment election must be made no later than the time of initial deferral (i.e., no later than the deadline by which an election to defer the amounts subject to the payment election may be submitted under the regulations).

Nonelective Arrangements. If a plan does not provide participants with an opportunity to elect the time and/or form of payment for amounts deferred under the arrangement, the form and/or timing of payment must generally be specified under the plan by the plan sponsor on or before the later of (i) the time the participant would have been required to submit a payment election for such amounts, or (ii) the time the participant obtains a legally binding right to the compensation.

Transition Relief Available Until December 31, 2007. The regulations provide that the transition relief contained in Notice 2006-79 continues to apply during 2007. As a result, plan sponsors have until December 31, 2007 to either designate the form and/or timing of payment or to allow participants to make new distribution elections for amounts subject to §409A. Note, however, that this transition relief for distribution elections cannot be utilized during 2007 with respect to amounts payable in 2007 or amounts that would become payable in 2007 as a result of a new distribution election.

Subsequent Changes in Form or Time of Payment

In general, any change to the form or timing of payments, whether made by a participant or the plan sponsor, after the required deadline for making an initial distribution election, must comply with the following requirements: (i) the change cannot take effect until at least 12 months after the election is submitted; (ii) the payments subject to the change (excluding payments upon death, disability or unforeseeable emergency) must be delayed at least 5 years from the date the payments would have otherwise been made; and (iii) any change related to a distribution at a specified time or pursuant to a fixed schedule must be submitted at least 12 months prior to the first payment subject to the change (or in the case of a life annuity or installment payments treated as a single payment, at least 12 months prior to the date the first amount was scheduled to be paid).

The regulations provide significant guidance regarding the application of these rules (such rules are referred to below as the “subsequent change rules”), as summarized below.

APPLICATION OF THE “SUBSEQUENT CHANGE RULES”

Issue	Provisions in the Regulations
<p>General Rules to Determine When a Change to a Benefit Payment is Deemed to be Made</p>	<p>The regulations provide guidance to determine when a change to the form or timing of payment is deemed to be made for purposes of applying the “subsequent change rules,” including:</p> <ul style="list-style-type: none"> ◆ Definition of “Payment.” For purposes of applying the “subsequent change rules”, the term “payment” refers to each separately identified amount a participant is entitled to receive on a determinable date under the plan. An amount is separately identified only if the amount may be objectively determined under a nondiscretionary formula (e.g., 10% of the account balance as of a specified date). ◆ Multiple Distribution Events. If the plan provides for payment upon two or more permissible distribution events specifically allowed by §409A (e.g., upon a fixed date or a separation from service, whichever is earlier), a plan may provide for a different form or timing of payment for each of the permissible distribution events. The regulations also provide that the “subsequent change rules” would <u>apply separately</u> to each payment due upon each distribution event. For example, a change elected by a participant to the form of payment due upon separation from service would not impact the participant’s distribution election for payments upon a fixed date. <i>Note that the permissible distribution events under §409A are discussed more fully in Part IV of this bulletin.</i> ◆ Addition or Deletion of a Permissible Distribution Event. If a plan is amended to add or delete a permissible distribution event that may result in a change to the time or form of payment of amounts <u>previously</u> deferred under the plan, the addition or deletion of the event would generally be subject to the “subsequent change rules.” ◆ Changes Elected by or Applicable to a Participant’s Beneficiary. The regulations clarify that the “subsequent change rules” apply to payment elections submitted by a participant’s beneficiary, as well as elections by the participant or the plan sponsor regarding the time and form of payments made to the participant’s beneficiary. However, a change in the identity of a beneficiary does not constitute a change in the time and form of payment. ◆ A Change is Not Considered to Be Made Until the Election Becomes Irrevocable under the Plan. The regulations provide that a distribution election to change the timing or form of a payment is not considered to be made for purposes of triggering the “subsequent change rules” until the election becomes irrevocable under the terms of the plan. As a result, where a plan allows participants to modify a previously submitted election to change the form or timing of payment, the prior election and any modification to such election will only be treated as <u>one change</u> for purposes of applying the “subsequent change rules,” provided that the election and any modification to the election are submitted and become irrevocable no later than the required deadline for making a change to the form or timing of payment under the regulations.

APPLICATION OF THE “SUBSEQUENT CHANGE RULES” (CONT.)

Issue	Provisions in the Regulations
<p>Application to Installment Payments</p>	<p>The regulations provide that a plan may treat a series of installment payments as either a <u>single payment</u> or a <u>series of separate payments</u> for purposes of applying the “subsequent change rules.”</p> <ul style="list-style-type: none"> ◆ Installment Payments Treated as a Single Payment. The right to a series of installment payments (that is not a life annuity) will be treated as the right to a <u>single payment</u>, unless the plan expressly provides that the right to a series of installment payments will at all times be treated as the right to a series of separate payments. If installments are treated as a single payment, an election to change the time and form of payment must be submitted no later than 12 months prior to the date on which the first amount in the series of installments is scheduled to be paid, and the payment of the installment stream must be delayed by at least 5 years from the date the first amount would otherwise have been paid. <p>Example— Installments Treated as a Single Payment Changed to a Lump Sum: If a participant is entitled to 5 annual installments designated as a single payment (rather than a series of separate payments) commencing on January 1, 2010, then by no later than January 1, 2009, the participant may elect to receive the entire amount (equal to the sum of all 5 of the installments) as a lump sum payment, on or after January 1, 2015. Because the right to the installment payments is designated as the right to a single payment, the five year delay requirement is measured from the date on which the first payment in the installment stream would have otherwise been made — i.e., the five year delay does <u>not</u> apply separately to each amount in the series of installments — and the remaining installment payments can be paid as part of the lump sum on January 1, 2015.</p> ◆ Installment Payments Treated as a Separate Payment. If a plan provides that installment payments will be treated as a series of separate payments, the “subsequent change rules” apply separately to each amount in the series of installments. <p>Example — Installments Treated as Separate Payments Changed to a Lump Sum: If a participant is entitled to 5 annual installments each of which is designated as a separate payment (rather than treated as a single payment) commencing on January 1, 2010, then by no later than January 1, 2009, the participant may elect to receive the entire amount (equal to the sum of all 5 of the installments) as a lump sum payment on or after January 1, 2019. Because the installments were designated as a series of separate payments, the “subsequent change rules” must be applied <u>separately to each payment</u> in the series of installments; as a result, the earliest date on which the entire payment stream could be paid as a lump sum is 5 years after the date of the last originally scheduled installment.</p> <p>Example — Installments Treated as Separate Payments: If a participant is entitled to 5 annual installments each of which is designated as a separate payment (rather than a single payment) commencing on January 1, 2010, then by no later than January 1, 2009, the participant may elect to delay the <u>first</u> payment until January 1, 2015 or later. Because the installments were designated as a series of separate payments, the second installment would be paid as originally scheduled on January 1, 2011 (i.e., it would not be impacted by the change to the first installment). Any other installment in that series could be delayed by separately applying the “subsequent change rules.”</p>

APPLICATION OF THE “SUBSEQUENT CHANGE RULES” (CONT.)

Issue	Provisions in the Regulations
<p>Application to Life Annuities</p>	<p>The entitlement to a “life annuity” (as described below) is treated as the entitlement to a <u>single payment</u> for purposes of applying the “subsequent change rules.” Importantly, the regulations provide that if, before any annuity payment has been made, a participant makes a change in the form of payment from one type of life annuity to another <u>actuarially equivalent</u> type of life annuity with the same scheduled date for the first annuity payment, the change will <u>not</u> be considered a change in the form or time of payment for purposes of §409A — i.e., the “subsequent change rules” do not apply.</p> <ul style="list-style-type: none"> ◆ Definition of “Life Annuity.” The regulations define the term “life annuity” as (i) a series of substantially equal periodic payments, payable not less frequently than annually, for the life (or life expectancy) of the participant, or (ii) a series of substantially equal periodic payments for the life (or life expectancy) of the participant, followed upon the death or end of the life expectancy of the participant by a series of substantially equal periodic payments, payable not less frequently than annually, for the life (or life expectancy) of the participant’s designated beneficiary. ◆ Certain Features are Disregarded in Determining Whether an Annuity May be Treated as a “Life Annuity.” In determining whether a form of payment is considered a “life annuity,” the following features are <u>disregarded</u>: <ul style="list-style-type: none"> • “term certain” features under which annuity payments continue for the longer of the life of the annuitant or a fixed period of time; • “pop-up” features under which payments increase upon the death of the beneficiary or upon another event that eliminates the right to a survivor annuity; • features under which an annuity form of payment provides higher periodic payments before the expected commencement of benefits under the Social Security Act or the Railroad Retirement Act, and lower periodic payments after such expected commencement date; • features providing for an increase in the annuity payment to reflect cost-of-living adjustments in a manner described in Treasury Regulation §1.401(a)(9)-6; and • “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. <p><i>Clark Consulting Note:</i> The features described above are <u>not</u> disregarded for purposes of determining whether a life annuity with such a feature is actuarially equivalent to a life annuity without such a feature.</p> ◆ Determining Whether Life Annuities are Actuarially Equivalent. The regulations provide that in determining whether life annuities are actuarially equivalent, the same actuarial assumptions and methods must be used in valuing each annuity payment option, and such assumptions must be reasonable. However, it is not required that the same actuarial methods and assumptions be used over the term of the participant’s participation in a plan. ◆ Joint and Survivor Annuities. The regulations clarify that a joint and survivor annuity will <u>not</u> fail to be treated as actuarially equivalent to a single life annuity due <u>solely</u> to the value of a subsidized survivor annuity benefit, provided that both (i) the annual lifetime annuity benefit available to the participant under the joint and survivor annuity is not greater than the annual lifetime annuity benefit available to the participant under the single life annuity alternative, and (ii) the annual survivor annuity benefit is not greater than the annual lifetime annuity benefit available to the participant under the joint and survivor annuity.

APPLICATION OF THE “SUBSEQUENT CHANGE RULES” (CONT.)

Issue	Provisions in the Regulations
Coordination with “Anti-Acceleration” Rules	<p>The regulations provide that a change in the form of a payment that results in a more rapid schedule for payments generally will <u>not</u> constitute an impermissible acceleration of a payment, provided that the change in the form of payment complies with the “subsequent change rules.”</p> <p>Example: A change in form from a 10-year installment payment treated as a <u>single payment</u> to a lump sum would not be an impermissible acceleration, provided the change complied with the subsequent change rules (e.g., the change is not effective for 12 months and the lump sum payment is not made until at least 5 years after the date the installment payments were scheduled to commence).</p>

IV. PERMISSIBLE DISTRIBUTIONS

Overview

§409A generally provides that payments may only be made at certain times or upon certain events specified in the statute (e.g., separation from service, disability, death, a specified time or pursuant to fixed schedule, upon a change in control, and upon an unforeseeable emergency). In addition, the statute provides that a plan may not permit any acceleration of the specified time or fixed schedule for paying benefits, except as provided by Treasury guidance. The regulations incorporate these rules and provide additional guidance on the requirements for a payment to be made in compliance with §409A.

General Requirements for Payments to be Made Upon a Permissible Distribution Event

The regulations include guidance on the general requirements for payments to be considered made upon a permissible distribution event provided in §409A (i.e., separation from service, disability, death, a change in control, or an unforeseeable emergency), as summarized below.

GUIDANCE FOR PAYMENTS TO BE CONSIDERED MADE UPON A PERMISSIBLE DISTRIBUTION EVENT

Issue	Provisions in the Regulations
<p>Payment Upon Multiple Permissible Distribution Events</p>	<p>Where a plan provides for payment upon two or more permissible distribution events, the plan may provide that payment will be made upon the <u>earlier of</u>, or the <u>later of</u>, the occurrence of such events. A plan may also provide that an intervening event that is a permissible distribution event may override an existing schedule already in payment status (e.g., a participant’s remaining account may be distributed in a lump sum if the participant dies while receiving installments that commenced upon separation from service).</p>
<p>Plan Must Designate a Payment Date</p>	<p>The regulations generally require that where a payment is based upon the occurrence of a permissible distribution event, the plan must designate an <u>objectively determinable and nondiscretionary</u> date or schedule upon which benefits triggered by the event will be paid.</p> <p>The regulations clarify that the “payment date” designated under a plan for payments to be made upon the occurrence of a permissible distribution event may be stated as an objectively determinable period following the event, but <u>only if</u> the period is restricted to either (i) a specified period of <u>no more than 90 days</u> following the event, (ii) a specified period following the event that both begins and ends within the <u>same</u> calendar year, or (iii) a specified calendar year following the event. If a payment may be made within a specified period of no more than 90 days following an event, for purposes of the application of the “subsequent change rules” the payment date is treated as the first possible date upon which the payment could be made.</p> <p>Example — Designation of Specified Period for Payment Date: A plan may provide that if a participant becomes disabled the “payment date” will be the 60-day period following the date on which the participant became disabled.</p> <p>Example — Designation of a Specified Calendar Year for Payment: A plan may provide that if a change in control occurs the “payment date” will be the first calendar year following the change in control.</p>

PERMISSIBLE DISTRIBUTIONS

GUIDANCE FOR PAYMENTS TO BE CONSIDERED MADE UPON A PERMISSIBLE DISTRIBUTION EVENT (CONT.)

Issue	Provisions in the Regulations
<p>When a Payment is Treated as Made Upon the Designated Payment Date</p>	<p>Payments Made After Designated Payment Date. A payment will be treated as having been made upon the designated payment date if the payment is made by the <u>later of</u> (i) the end of the calendar year containing the designated date, or (ii) the 15th day of the third month following the designated payment date and the participant is not permitted, directly or indirectly, to designate the taxable year of the payment.</p> <p>Payments Made Before Designated Payment Date. Under the regulations, a payment will also be treated as having been made upon the date specified under the plan and will not be treated as an impermissible acceleration if the payment is made <u>no earlier than 30 days before the designated payment date</u> and the participant is not permitted, directly or indirectly, to designate the taxable year of the payment.</p>
<p>Plan May Designate a Fixed Schedule For Payment</p>	<p>A plan may provide that following the occurrence of a permissible distribution event, payment will be made in accordance with a fixed schedule that is <u>objectively determinable and nondiscretionary</u> as of the date of the event, provided that the schedule is fixed no later than the time the permissible payment event is designated, and any change to the fixed schedule is made in accordance with the rules of §409A regarding a change in the time and form of payment.</p> <p>Example: A plan may provide that an employee will be entitled to three substantially equal annual installment payments commencing as of the first anniversary of the participant’s separation from service.</p>
<p>When Alternative Payment Schedules May be Tied to a Permissible Distribution Event</p>	<p>General Rule – Only One Payment Schedule Allowed for a Permissible Distribution Event. A plan may not designate more than one payment schedule (i.e., time and form of benefit payments) for a permissible distribution event, except as permitted in the limited circumstances described below. For example, a plan may <u>not</u> provide alternative payment schedules for benefits triggered by a participant’s separation from service based on whether the participant’s separation from service was voluntary or involuntary.</p> <p>Limited Circumstances Where Alternative Payment Schedules May be Tied to a Permissible Distribution Event. Under limited circumstances, a plan may designate more than one payment schedule for a permissible distribution event. However, as summarized below, the regulations distinguish between the circumstances under which alternative payment schedules may be tied to a participant’s separation from service and the circumstances under which alternative payment schedules may be tied to the other permissible distribution events under §409A, such as a change in control or disability.</p> <ul style="list-style-type: none"> • <u>Alternative Payment Schedules Tied to a Participant’s Separation from Service.</u> With respect to benefit payments triggered by a participant’s separation from service, a plan may provide for alternative payment schedules for the benefits under each of the following circumstances: <ul style="list-style-type: none"> ⇒ Where the separation from service occurs during a specified period of time (<u>not to exceed 2 years</u>) following the occurrence of a “change in control event” (as defined in the regulations); ⇒ Where the separation from service occurs before or after a specified date (e.g., such as the attainment of a specified age), or before or after a combination of a specified date and years of service (determined pursuant to an objective formula); and ⇒ Where the separation from service occurs under circumstances other than those described above.

PERMISSIBLE DISTRIBUTIONS

GUIDANCE FOR PAYMENTS TO BE CONSIDERED MADE UPON A PERMISSIBLE DISTRIBUTION EVENT (CONT.)

Issue	Provisions in the Regulations
<p>When Alternative Payment Schedules May be Tied to a Permissible Distribution Event (Cont.)</p>	<p><u>Example – Alternative Payment Schedules Tied to Separation from Service:</u> An arrangement may provide that an employee’s account balance will automatically be paid in a lump sum if the employee experiences a separation from service prior to attainment of age 55 and 10 years of service (determined pursuant to an objective formula), but the employee will receive his or her account balance in 10 annual installment payments if the participant experiences a separation from service on or after the attainment of age 55 and 10 years of service (determined pursuant to an objective formula).</p> <ul style="list-style-type: none"> • <u>Alternative Payment Schedules Tied to the Other Permissible Distribution Events.</u> With respect to benefit payments triggered by a permissible distribution event (other than separation from service), such as a change in control event or a disability, a plan may only provide for an alternative payment schedule based upon whether the event occurs on or before one (<u>but not more than one</u>) specified date. <p><u>Example – Alternative Payment Schedules Tied to a Change in Control:</u> An arrangement may provide that an employee’s account balance will automatically be paid in a lump sum if a change in control occurs prior to the employee’s attainment of age 60, but the employee will receive his or her account balance in 5 annual installment payments if a change in control should occur on or after the employee’s attainment of age 60.</p>

Guidance Regarding Whether a Separation from Service has Occurred

A plan may allow for payments to be made upon a participant’s separation from service (as determined in accordance with the regulations). The regulations provide guidance on when a participant has experienced a separation from service for purposes of §409A, as summarized below.

GUIDANCE REGARDING WHETHER A SEPARATION FROM SERVICE HAS OCCURRED

Issue	Provisions in the Regulations
<p>Application of “Controlled Group” Rules</p>	<p>All Entities Within a “Controlled Group” Treated as a Single Employer. Under the regulations, a participant’s “employer” for purposes of determining whether the participant has experienced a separation from service is determined on a “controlled group” basis — i.e., all entities within a “controlled group,” as defined under the Internal Revenue Code, are treated as a <u>single employer</u>. This means, for example, that a transfer of an employee from a parent to a subsidiary or a transfer between a brother/sister entity generally would not constitute a separation from service under §409A.</p> <p>General Rule Regarding the Ownership Percentage to be Used in Applying the “Controlled Group Rules.” The regulations provide that for purposes of determining whether a participant has experienced a separation from service under §409A, the 80% minimum ownership percentage that otherwise must be used when applying the “controlled group” rules under the Internal Revenue Code <u>should be substituted with a 50%</u> minimum ownership percentage (unless another percentage is designated under the terms of the plan in accordance with the §409A regulations).</p>

GUIDANCE REGARDING WHETHER A SEPARATION FROM SERVICE HAS OCCURRED (CONT.)

Issue	Provisions in the Regulations
<p>“Same Desk Rule” May be Applied upon a Substantial Asset Sale</p>	<p>In general, a sale of substantial assets (e.g., a division or a plant) by an employer to an unrelated buyer will constitute a separation from service with respect to the former employees of the seller who are transferred to the buyer in connection with the transaction. However, the regulations provide that the seller and buyer may specify in advance that the former employees of the seller who are transferred to the buyer will <u>not</u> be treated as having experienced a separation from service from the seller for purposes of §409A, provided that:</p> <ul style="list-style-type: none"> • The asset purchase results from bona fide, arm’s length negotiations between the parties; • All similarly situated employees are treated consistently; and • Such treatment is designated in writing no later than the closing date of the asset purchase.
<p>Separation From Service for Employees</p>	<p>An employee is generally considered to have experienced a separation from service if the employee dies, retires, or otherwise has a termination of employment with the employer. Additional guidance to determine whether or not an employee experiences a separation from service is described below.</p> <ul style="list-style-type: none"> ◆ Determination of a Separation from Service is Based on Facts and Circumstances. The regulations provide that whether an employee has experienced a separation from service under §409A must be determined based on whether the facts and circumstances indicate that the employer and employee reasonably anticipated that after a certain date either: <ul style="list-style-type: none"> • No further services would be performed by the employee, <u>or</u> • The level of bona fide services to be performed for the employer (as either an employee or an independent contractor) would permanently decrease to <u>no more than 20%</u> of the average level of services rendered during the <u>immediately preceding three full calendar years</u> (or, if the employee provided services for less than three years, such lesser period), determined without regard to any period during which the employee was on a unpaid bona fide leave of absence. ◆ Plan May Specify Alternate Threshold For Reduction in Services. A plan may treat another level of anticipated permanent reduction in the level of bona fide services as a separation from service (e.g., a phased retirement), provided that the level is set forth in the plan as a <u>specific percentage</u> and such percentage <u>is greater than 20% but less than 50%</u> of the average level of services provided during the previous 3-year period. Once designated, any change to the definition of “separation from service” with respect to amounts previously deferred will trigger application of the “subsequent change rules.” ◆ Examples of Factors to Be Considered in Determining Whether a Separation from Service has Occurred. Factors to be considered in determining whether the employer and the employee reasonably anticipated that the bona fide level of services to be performed after a certain date would permanently decrease to no more than 20% (or such higher percentage specified in the plan) of the level of services performed during the previous 3-year period, include: <ul style="list-style-type: none"> • Whether the employee continues to be treated as an employee for other purposes (e.g., continuation of salary and participation in other employee benefit programs sponsored by the employer); and • Whether similarly situated employees have been treated consistently.

GUIDANCE REGARDING WHETHER A SEPARATION FROM SERVICE HAS OCCURRED (CONT.)

Issue	Provisions in the Regulations
<p>Separation From Service for Employees (Cont.)</p>	<p>◆ Certain Presumptions Apply. Under the regulations, an employee is presumed to have separated from service where the level of bona fide service decreases to less than or equal to 20% of the average level of services rendered during the immediately preceding three full calendar years (or, if the employee provided services for less than three years, such lesser period). Conversely, an employee will be presumed <u>not</u> to have experienced a separation from service where the level of services continue at a level equal to 50% or more of the average level of services rendered during the immediately preceding three full calendar years (or, if the employee provided services for less than three years, such lesser period). No presumption applies where the level of services has decreased to a level that is more than 20% but less than 50% over the applicable period. These presumptions may be rebutted based on the factors described above.</p>
<p>Leave of Absence Generally Not a Separation from Service</p>	<p>Under the regulations, a leave of absence (e.g., military leave, sick leave, etc.) is <u>not</u> considered to be a separation from service, unless (i) the period of leave exceeds six months, and (ii) the individual is not provided with a continued right to employment either by statute or contract. If the period of leave exceeds six months and the individual does not retain a right to reemployment, the regulations provide that the individual would generally be deemed to have experienced a separation from service on the first date immediately following the six month period.</p>
<p>Separation From Service for Independent Contractors</p>	<p>General Rule – Separation from Service Does Not Occur Until there is a Complete Termination of Contractual Relationship. An independent contractor is generally considered to have experienced a separation from service 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, provided that the expiration constitutes a <u>good faith and complete termination of the contractual relationship</u> (i.e., the company does not anticipate a renewal of the contractual relationship or that the independent contractor will become an employee).</p> <p>“Safe Harbor” Rule Incorporated in Regulations. The regulations incorporate a “safe harbor” rule pursuant to which a plan will be considered to have made a payment due to the separation from service of an independent contractor, but only if the plan provides that:</p> <ul style="list-style-type: none"> • No amount will be paid to the independent contractor prior to the end of the 12-month period following the date on which the contract with the independent contractor expires (or in the case of more than one contract, all contracts); and • No amount payable to the independent contractor in accordance with the provision above will actually be paid if, after the expiration of the contract (or contracts) and before that payment date, the individual performs services for the service recipient as either an independent contract or an employee.

GUIDANCE REGARDING WHETHER A SEPARATION FROM SERVICE HAS OCCURRED (CONT.)

Issue	Provisions in the Regulations
<p>Separation from Service for an Individual Who is Both an Employee and an Independent Contractor</p>	<p>General Rule – Separation from Service Does Not Occur Until Termination as <u>Both</u> an Employee and an Independent Contractor. Subject to the exception described below, where an individual provides services as both an employee and as an independent contractor, a separation from service generally does not occur under §409A until the individual terminates as both an employee and an independent contractor.</p> <p>Exception – Separation from Service of an “Inside” Director. Where an individual provides services as both an employee and as a member of the board of directors, and participates in separate nonqualified deferred compensation plans as an employee and a director (determined in accordance with the “plan aggregation rules”), the regulations provide that a termination of service as an employee will constitute a separation from service for purposes of the employee plan, <u>even if</u> the individual continues to provide services as a director. Likewise, a termination of service as a director will constitute a separation from service for purposes of the director plan, <u>even if</u> the individual continues to provide services as an employee.</p>
<p>Employer May Not Suspend Payments in the Event of Rehire</p>	<p>The regulations clarify that if an employer rehires a former employee/service provider who is receiving (or eligible to receive) benefit payments from the employer’s nonqualified deferred compensation plan, the employer <u>cannot</u> suspend/delay such benefit payments following the rehire of the participant, because to do so would violate the “subsequent change rules” of §409A.</p>

Payments Triggered by Separation from Service of a “Key Employee”

§409A generally requires that payments triggered by the separation from service of a “key employee” of a publicly traded company must be delayed for a period of at least six months following the participant’s separation from service (unless the participant dies during the delay – eliminating the requirement). The regulations provide guidance on the identification of “key employees” for purposes of this rule, as described more fully below.

IDENTIFICATION OF “KEY EMPLOYEES”

Issue	Provisions in the Regulations
<p>Required Delay for “Key Employees” Only Applies to Publicly Traded Entities</p>	<p>General Rule under §409A. The requirement to impose a 6-month delay in payments triggered by the separation from service of a “key employee” only applies to an employer (determined by applying the IRC “controlled group” rules) whose stock is publicly traded on an “established securities market or otherwise.”</p> <p>Definition of “Established Securities Market” includes Foreign Markets. The regulations define “established securities market” by reference to the rules in Treasury Regulation §1.897-1(m), which generally includes foreign securities markets. As a result, the 6-month delay will apply to payments triggered by the separation from service of the “key employees” (as defined below) of any “employer” (determined by applying the IRC “controlled group” rules) whose stock is publicly traded solely on a foreign exchange, or whose stock is traded on a U.S. exchange in the form of American Depositary Receipts (ADRs).</p>

IDENTIFICATION OF “KEY EMPLOYEES” (CONT.)

Issue	Provisions in the Regulations
<p>Definition of “Key Employee”</p>	<p>General Rule under §409A. In general, §409A provides that all individuals who fall within the definition of “key employee,” as defined under IRC §416(i) (determined without regard to IRC §416(i)(5)), for the applicable period are subject to the 6-month delay requirement for payments triggered by a separation from service.</p> <p>Overview of “Key Employee” Definition under IRC §416(i). Under IRC §416(i), the term “key employee” is defined to include:</p> <ul style="list-style-type: none"> • a 1% owner of the company whose annual compensation exceeds \$150,000; • a 5% owner of the company; and • any “officer” whose annual compensation for the 12-month identification period ending December 31, 2006 exceeds \$140,000. Note that this compensation limit is adjusted annually by the IRS for cost of living. <ul style="list-style-type: none"> ⇒ For employers with more than 500 employees, the rules of IRC §416(i) limit the number of “officers” that must be treated as “key employees” to <u>no more than 50</u>. ⇒ The term “officer” is not specifically defined in IRC §416(i); however, Treasury Regulation §1.416-1 (in Question T-13) provides guidance on the factors that should be considered in determining whether an employee is an “officer.” These factors include the source of the employee’s authority, the term for which the employee is appointed or elected, and the nature and extent of the employee’s duties.
<p>Definition of “Compensation” to be used for Identifying “Key Employees”</p>	<p>Employers May Use Same Definition of “Compensation” Used in their Qualified Retirement Plan. When identifying “key employees,” the §409A regulations require employers to use one of the available definitions of “compensation” provided under IRC §415 and related regulations – i.e., the Code section and regulations that define “compensation” applicable to qualified retirement plans. In determining which definition of “compensation” to use, an employer may elect to use the same definition of “compensation” being used under a qualified retirement plan sponsored by such employer, provided the definition of “compensation” used under the employer’s qualified plan complies with IRC §415 and related regulations.</p> <p>Anti-Abuse Rules Regarding Application of (or Changes to) Definition Used by the Employer. In applying a definition of “compensation” for purposes of its “key employee” determination, the §409A regulations provide certain limitations, including:</p> <ul style="list-style-type: none"> • The definition of “compensation” used by the employer must be applied consistently to <u>all</u> employees; and • Once an employer’s list of “key employees” <u>has become effective</u> (pursuant to the rules described below), the employer cannot change the definition of “compensation” used to determine the list.

IDENTIFICATION OF “KEY EMPLOYEES” (CONT.)

Issue	Provisions in the Regulations
<p>Identification Date and Effective Date for Determining “Key Employees”</p>	<p>Identification Date for Determining “Key Employees.” The regulations provide that “key employees” should be identified based on the 12-month period ending on <u>December 31</u>, unless the employer has chosen to designate another identification date.</p> <p>Effective Date of the “Key Employee” List. All individuals who are identified as “key employees” as of the identification date are subject to a 6-month delay in payments triggered by a separation from service that occurs during the 12-month period that begins on the first day of the 4th month following the identification date, unless an earlier effective date is designated by the employer.</p> <p>Example: Where December 31 is the identification date applicable to the employer’s nonqualified plan, all individuals identified as “key employees” for the calendar year ending December 31, 2007, would be subject to a 6-month delay in payments triggered by a separation from service that occurs during the period of April 1, 2008 through March 31, 2009.</p> <p><i>Clark Consulting Note:</i> The regulations provide that an employer may select an alternative identification date and/or effective date, provided that (i) the designated identification date and/or effective date must be used consistently for all nonqualified deferred compensation plans, and (ii) any change to the date(s) cannot be effective for a period of at least 12 months.</p>
<p>Alternative Methods for Applying the 6-Month Delay</p>	<p>Employer May Impose Delay on All Participants. The regulations clarify that an employer may choose to impose the 6-month delay requirement on <u>all</u> participants (i.e., both “key” and non-key employees).</p> <p>Other Alternative Methods May be Used by an Employer Subject to Certain Restrictions. In addition, the regulations permit an employer to use another alternative method for identifying the employees who will be subject to the six-month delay requirement upon separation from service, provided that (i) the method is reasonably designed to include all “key employees” (as defined in IRC §416(i), (ii) the method is objectively determinable and participants are not provided any election regarding application of the rule, and (iii) the method does <u>not</u> result in <u>more than 200 service providers</u> being included in the class subject to the required delay as of any date.</p>

IDENTIFICATION OF “KEY EMPLOYEES” (CONT.)

Issue	Provisions in the Regulations
<p>Determination of “Key Employees” After Certain Corporate Transactions</p>	<p>The regulations provide guidance regarding the determination of “key employees” after certain corporate transactions (e.g., a merger of two public companies, a merger of a public and private company, a spin-off, or an initial public offering).</p> <p>For example, where <u>two public companies merge</u>, the regulations provide the following guidance for determining the “key employees” of the resulting entity:</p> <p>◆ Method for Determining the Resulting Entity’s “Key Employee” List Immediately Following Merger. During the period following the merger of two public companies, but <u>prior to</u> the next effective date for the “key employee” list of the resulting entity, the resulting entity’s “key employees” include:</p> <ul style="list-style-type: none"> • The top-50 most highly compensated individuals of the resulting entity, determined by combining the “key employee” lists that had been maintained by each entity as of the date the merger became effective and ranking all individuals who appear on the combined list in order of compensation; and • Any other individual who does not fall within such top-50 most highly compensated group but who is determined to either be a 1% owner with annual compensation in excess of \$150,000 or a 5% owner during such period. <p><i>Clark Consulting Note:</i> The preamble to the regulations provides that the resulting entity may choose to simply preserve the pre-transaction lists of “key employees” of the two pre-merger entities without using the method described above (i.e., treat <u>all</u> individuals on the two lists as “key employees” of the resulting entity) where it is determined it would be administratively less burdensome.</p> <p>◆ Determining the Applicable Identification Period and Effective Date for the Resulting Entity’s Next “Key Employee” List. The next identification date and effective date for the resulting entity’s “key employee” list will be the same identification date and effective date that the acquiring entity would have used had the merger not occurred.</p>

Disability

§409A allows payments to commence upon a participant's disability; however, it specifically defines the conditions under which a participant may be considered "disabled." The regulations incorporate the definition of disability provided in §409A. The regulations also clarify that a plan may have a more limited definition of disability than the one provided in §409A, provided that any disability upon which a payment is made must comply with the requirements of §409A. For purposes of determining whether or not an employee is disabled, a plan may provide that an employee will be deemed to be disabled (i) if the employee is determined to be totally disabled by the Social Security Administration, or (ii) if the employee is determined to be disabled in accordance with the employer's disability insurance program (provided the disability definition in such program complies with the requirements of §409A).

Change in Control

§409A allows for payments to commence upon a change in control, provided that the plan definition of "change in control" complies with the definition provided by Treasury. In general, the regulations provide that payments may be made upon the occurrence of one or more of the following "change in control events":

- a "change in the ownership" of the corporation – defined under the regulations as the acquisition by one person (or more than one person acting as a group) of more than 50% (or such higher percentage designated in the plan) of the total fair market value or total voting power of a corporation;
- a change in "effective control" of the corporation – defined under the regulations as either (i) the acquisition by one person (or more than one person acting as a group) of stock possessing more than 30% (or such higher percentage designated in the plan) of the total voting power of a corporation during the 12-month period ending on the date of the most recent acquisition, or (ii) the replacement of a majority (or such higher portion designated in the plan) of the members of the corporation's board during any 12-month period by directors whose appointment or election is not endorsed by a majority (or such higher portion) of the members of the board as constituted immediately prior to the date of such appointment or election;
- a change in the ownership of a "substantial portion" of the assets of the corporation – defined under the regulations as the acquisition of the assets of a corporation with a total gross fair market value equal to or more than 40% (or such higher percentage designated in the plan) of the total gross fair market value of all assets of the corporation determined immediately prior to such acquisition.

In order to qualify as a "change in control event," the regulations require that the occurrence of the event must be objectively determinable. The regulations also clarify that a plan may provide for payment upon the occurrence of one or more "change in control events" specified in the plan, but is not required to provide for payment upon all of the "change in control events" described above.

Payments Upon a Specified Time or Pursuant to a Fixed Schedule

§409A allows for payments to be made upon a specified time or pursuant to a fixed schedule. The regulations provide that an amount is considered to be payable upon a specified time or pursuant to a fixed schedule if (i) the amount, and (ii) the specific payment date or the calendar year in which payment will be made, are nondiscretionary and "objectively determinable" at the time of deferral. For purposes of this rule, an amount is considered to be objectively determinable if the amount is either specifically identified, or is able to be determined pursuant to an objective, nondiscretionary formula (e.g., 50% of a participant's account balance) specified at the time of deferral. If a plan designates the calendar year in which payment will be made, rather than designating the specific payment date, the specified time or fixed schedule for such payment is deemed to be January 1st for purposes of applying the "subsequent change rules" of §409A regarding a change in the form or timing of payment.

Clark Consulting Note: A specified time or a fixed schedule may be designated as a defined period within the participant's taxable year, provided that no such defined period may begin within one taxable year and end in another taxable year. For example, a plan may specify that a payment will be made within the 60 day period following January 1, 2010, but may not specify that a payment will be made within the 60 day period following December 1, 2010 (as the defined period of 60 days would extend into another taxable year).

PERMISSIBLE DISTRIBUTIONS

Unforeseeable Emergency

§409A allows for a payment to be made upon the occurrence of an unforeseeable emergency, provided the payment is made in compliance with the requirements of the regulations. The regulations provide guidance regarding the circumstances under which a payment may be made upon an unforeseeable emergency, as described more fully below.

PAYMENTS UPON AN UNFORESEEABLE EMERGENCY

Issue	Provisions in the Regulations
Determination of “Unforeseeable Emergency”	<p>The regulations generally incorporate the definition of “unforeseeable emergency” provided in §409A. Specifically, “unforeseeable emergency” is defined under the regulations as a severe financial hardship of the service provider resulting from:</p> <ul style="list-style-type: none"> ◆ 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 IRC §152); ◆ the loss of the service provider’s property due to casualty; or ◆ other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the service provider. <p><i>Clark Consulting Note:</i> The regulations provide that the determination of whether a participant has experienced an unforeseeable emergency is based on the relevant facts and circumstances of each case. The regulations also clarify that (i) a plan may provide for payment upon specific types of unforeseeable emergencies, but is not required to provide for payment upon all unforeseeable emergencies described above, and (ii) a plan may provide a participant with discretion to make a request to the plan sponsor for a payment upon an unforeseeable emergency.</p>
Examples of Events that May Constitute an Unforeseeable Emergency	<p>The regulations provide the following examples of events that may constitute an “unforeseeable emergency,” depending on the facts and circumstances :</p> <ul style="list-style-type: none"> ◆ The need to rebuild a home as a result of a natural disaster not otherwise covered by insurance. ◆ The imminent foreclosure or eviction from the service provider’s primary residence. ◆ The need to pay for medical expenses, including non-refundable deductibles, as well as costs for prescription medication. ◆ The need to pay for funeral expenses of a spouse, beneficiary or a dependent.
Examples of Events that Do NOT Constitute an Unforeseeable Emergency	<p>The regulations indicate that the following would <u>not</u> constitute an “unforeseeable emergency”:</p> <ul style="list-style-type: none"> ◆ The payment of college tuition. ◆ The purchase of a home (except as otherwise described above).

PAYMENTS UPON AN UNFORESEEABLE EMERGENCY

Issue	Provisions in the Regulations
<p>Limitations on the Amount of Payment Upon Unforeseeable Emergency</p>	<p>The regulations provide the following limitations on the amount of payment that may be made upon a unforeseeable emergency:</p> <ul style="list-style-type: none"> ◆ A distribution on account of an unforeseeable emergency may <u>not</u> be made to the extent that the emergency is or may be relieved (i) through reimbursement or compensation from insurance or otherwise, (ii) by liquidation of the participant’s assets, to the extent the liquidation would not itself cause severe financial hardship, or (iii) by cessation of deferrals under the plan. ◆ Amounts payable due to 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). ◆ A determination of the amount necessary to satisfy the emergency must also take into account any additional compensation that is available to the participant if the plan provides for termination of the participant’s deferral election following an unforeseeable emergency (as described below). <p><i>Clark Consulting Note:</i> The regulations clarify that in determining the amount reasonably necessary to satisfy the emergency, the employer is <u>not</u> required to consider payments that may be available to the employee due to the unforeseeable emergency under any other qualified plans or nonqualified plans maintained by the employer.</p>
<p>Cancellation of Deferral Elections Due to Unforeseeable Emergency</p>	<p>A plan may provide for a cancellation of a service provider’s deferral elections, or such a cancellation may be made, due to (i) an unforeseeable emergency, or (ii) a hardship distribution under the employer’s 401(k) plan pursuant to Treasury Regulation §1.401(k)-1(d)(3). The deferral election must be cancelled, not merely postponed or otherwise delayed.</p>

Acceleration of Payments

§409A provides that, generally, a plan may not permit any acceleration of the time or schedule for paying benefits (the “anti-acceleration rule”), except as provided in the regulations. The regulations provide limited exceptions to the anti-acceleration rule pursuant to which a plan sponsor may accelerate the payment of benefits without such action being treated as a change to the time or form of payment under §409A. Below is a summary of certain exceptions to the anti-acceleration rule contained in the regulations.

CERTAIN EXCEPTIONS TO THE ANTI-ACCELERATION RULE

Issue	Provisions in the Regulations
<p>Payments Upon Income Inclusion Under §409A</p>	<p>A plan may permit the acceleration of the time or schedule of a payment in order to pay any amount that is required to be includible in the income of a participant as a result of the failure of the plan to comply with the requirements of §409A and the regulations.</p>
<p>Payment of Employment Taxes</p>	<p>A plan may permit the acceleration of the time or schedule of a payment in order to pay FICA and other employment taxes on compensation deferred under the plan, including an amount necessary to pay related income tax on the payment. However, the accelerated payment cannot exceed the aggregate of the amount necessary to pay FICA and other employment taxes and the income tax withholding related to such amount.</p>
<p>Limited Cashouts and Permissible Acceleration of Installment Payments</p>	<p>A plan may provide that a participant’s benefit will automatically be paid in a lump sum under the following circumstances:</p> <ul style="list-style-type: none"> ◆ Limited Cashouts. A plan may require, or provide an employer with discretion to, immediately distribute all amounts deferred by a participant under a plan (determined based on the “plan aggregation rules”) in a mandatory lump sum if it is determined that the total amount deferred under such plan does not exceed a “specified amount.” The regulations provide that the “specified amount” may be any amount up to, but not greater than, the IRC §402(g) limitation applicable to elective deferrals under a qualified plan in effect for the year. <p>In order for such a distribution to be made in compliance with the regulations, the following requirements must be satisfied:</p> <ul style="list-style-type: none"> • a plan term or amendment reflecting the limited cashout provision must be executed and effective, and any required exercise of discretion by the employer must be evidenced in writing, no later than the payment date; • the payment must result in the termination and liquidation of the entirety of the participant’s interest in all nonqualified deferred compensation arrangements that are treated as having been deferred under a single plan under the “plan aggregation rules;” and • the amount of the payment cannot exceed the applicable dollar amount under IRC §402(g)(1)(B) in effect for the year (e.g., \$15,500 in 2007). <ul style="list-style-type: none"> ◆ Permissible Acceleration of Installments When the Remainder of Amounts Deferred Falls below a Predetermined Amount. A plan may provide that after installment payments have commenced, the participant’s entire remaining interest under the plan will be immediately distributed in a lump sum upon a determination that the present value of the remainder of the participant’s interest in the plan has fallen below a predetermined amount. In order to comply with the regulations, (i) the feature (including the predetermined amount) must be established no later than the time at which the time and form of payment must be established under the plan, and (ii) any change to such feature must be treated as a change in time or form of payment and therefore triggers application of the “subsequent change rules.” <p><i>Clark Consulting Note:</i> Unlike the requirements applicable to “limited cashouts,” the regulations do <u>not</u> impose a maximum limitation on the predetermined amount that may be established under the plan for triggering an acceleration of unpaid installment payments.</p>

CERTAIN EXCEPTIONS TO THE ANTI-ACCELERATION RULE (CONT.)

Issue	Provisions in the Regulations
Domestic Relations Order	Benefits may be paid to an individual other than the service provider to the extent necessary to satisfy a domestic relations order (as defined in IRC §414(p)(1)(B)).
Cancellation of Deferral Elections Due to Unforeseeable Emergency	A plan may provide for a cancellation of a service provider’s deferral elections, or such a cancellation may be made, due to (i) an unforeseeable emergency, or (ii) a hardship distribution under the employer’s 401(k) plan pursuant to Treasury Regulation §1.401(k)-1(d)(3). The deferral election must be cancelled, not merely postponed or otherwise delayed.
Payments Upon Plan Terminations and Liquidations in Limited Circumstances	<p>In general, a plan termination is <u>not</u> a permissible distribution event under §409A (i.e., a provision that allows the employer to terminate the plan and immediately distribute plan benefits is prohibited). However, the regulations do provide the following limited exceptions to this rule:</p> <ul style="list-style-type: none"> ◆ Upon the Occurrence of a “Change in Control Event.” A plan may provide for employer discretion to terminate and liquidate the plan (i.e., immediately distribute benefits) within the 30 days before, or 12 months following, a “change in control event” (as defined in the regulations), provided that all other nonqualified deferred compensation arrangements that would be classified as a single plan (determined as if the same service provider participated in such arrangements) are also terminated and liquidated with respect to each participant that experienced the change in control event. All affected participants are required to receive all amounts deferred under the terminated plan(s) within 12 months after the date the service provider irrevocably takes all necessary action to terminate and liquidate the plan(s). ◆ Termination of all Arrangements of the Same Type. An employer may terminate a plan provided that (i) the termination or liquidation does <u>not</u> occur proximate to a downturn in the financial health of the employer, (ii) all nonqualified deferred compensation arrangements that are treated as a single plan under the “plan aggregation rules” (e.g., elective account balance plans) are terminated with respect to <u>all</u> participants, (iii) no payments, other than those payments that would otherwise have been payable under the terms of the arrangements if the termination had not occurred, are made within 12 months of the termination, (iv) all payments are made within 24 months of the date the employer takes all necessary action to irrevocably terminate and liquidate the arrangements, and (v) the employer does not adopt a new arrangement of the same type that was terminated (i.e., elective account balance plan, nonaccount balance plan, etc.) for a period of 3 years following the date of termination. ◆ Corporate Dissolution or Bankruptcy. A plan may provide for plan termination upon a corporate dissolution or with the approval of a bankruptcy court.
Acceleration of Vesting	The waiver or acceleration of a condition that constitutes a substantial risk of forfeiture is not considered to be an impermissible acceleration of payment, provided any payment of such amount is made in accordance with the requirements of §409A.

Delay in Payments Permitted in Limited Circumstances

In general, a plan may not provide for discretion to delay or extend payments, unless such a delay is treated as a change in the time or form of payment (and therefore is made in compliance with the “subsequent change rules”). However, the regulations do include limited circumstances in which payments may be delayed without being treated as a change to the time or form of payment under §409A, including:

- ◆ **Amounts that would not be deductible due to application of IRC §162(m).** A payment may be delayed where the employer reasonably anticipates that if the payment were made as scheduled, the employer’s deduction with respect to the payment would not be permitted due to the application of Internal Revenue Code §162(m).

In order to comply with the regulations, the delayed payment must be made either (i) during the participant’s first taxable year during which the employer reasonably anticipates (or should reasonably anticipate) that the employer’s deduction with respect to the payment would not be limited/eliminated due to the application of Internal Revenue Code §162(m), or (ii) during the period beginning with the date on which the participant experiences a separation from service and ending on the later of (A) the last day of the taxable year in which the separation from service occurs or (B) the 15th day of the third month following the participant’s separation from service. The regulations require that any delay in a payment to a participant under this rule will not be exempted from the “subsequent change rules” unless all scheduled payments to the participant that could be delayed are, in fact, delayed.

Clark Consulting Note: Where a payment is delayed in accordance with this rule, and the payment is to be made on or after a participant’s separation from service, the regulations provide that the payment of such amount must be treated as a payment upon a separation from service and therefore if the participant is determined to be a “key employee” for the applicable period, the employer cannot make such payment any sooner than 6 months following the participant’s separation from service.

- ◆ **Payments that would violate Federal securities laws or other applicable law.** A plan may provide that a payment will be delayed where the employer reasonably anticipates that the making of such payment would violate Federal securities laws or other applicable law. The payment must be made at the earliest date at which the employer reasonably anticipates that the making of the payment will not cause such a violation.

In order to comply with the regulations related to delay of payments, the regulations also require the employer to treat all payments made to similarly situated participants on a reasonably consistent basis.

V. “PLAN AGGREGATION RULES”

For purposes of applying certain requirements of §409A, all nonqualified deferred compensation arrangements between a service provider and a service recipient that fall within the same category under the “plan aggregation rules” are treated as a single “plan.” The “plan aggregation rules” apply, for example, in calculating amounts includible in a participant’s income and related penalties due to a failure of a “plan” to comply with §409A (e.g., if there is a violation of §409A with respect to amounts deferred by or on behalf of a participant under one arrangement, all amounts deferred by or on behalf of that participant under all arrangements that are treated as a single plan under the “plan aggregation rules” would be subject to the income inclusion and penalty provisions of §409A).

In the proposed regulations, the application of the “plan aggregation rules” was based on four categories of “plans” — account balance plans, nonaccount balance plans, separation pay plans and “all other” plans. The final regulations expand the number of “plan” categories to nine. For example, the regulations provide flexibility to divide an account balance plan (e.g., an arrangement that includes both voluntary deferrals and employer matching contributions) into two separate categories – “elective” account balance plans and “nonelective” account balance plans. The regulations also create separate categories of “plans” for split-dollar life insurance arrangements, reimbursement plans, stock rights and foreign plans to the extent such arrangements are subject to §409A. The expansion of the number of “plan” categories in the final regulations is generally favorable for participants because, for example, it may mitigate the potential impact of a §409A violation.

The table below summarizes the guidance provided in the regulations regarding the application of the “plan aggregation rules.”

“PLAN AGGREGATION RULES”

Issue	Provisions in the Regulations
<p>General Categories of “Plans”</p>	<p>Under the regulations, the “plan aggregation rules” are applied based on the following categories of “plans”:</p> <ul style="list-style-type: none"> ◆ “Elective” Account Balance Plans — e.g., all voluntary deferrals by a participant and earnings attributable to such amounts under all arrangements sponsored by a service recipient that are considered to be an “account balance plan,” as determined in accordance with the regulations; ◆ “Non-Elective” Account Balance Plans — e.g., all non-elective contributions and earnings attributable to such amounts credited on behalf of a participant under all arrangements sponsored by a service recipient that are considered to be an “account balance plan,” as determined in accordance with the regulations; ◆ Nonaccount Balance Plans — e.g., all deferred compensation accrued with respect to a participant under all arrangements sponsored by a service recipient that are considered to be a “nonaccount balance plan,” as determined in accordance with the regulations; ◆ Separation Pay Plans — e.g., all amounts deferred with respect to a participant under all separation pay plans sponsored by a service recipient that are payable solely upon an involuntary separation from service, as determined in accordance with the regulations, or as a result of participation in a window program; ◆ Reimbursement Plans — e.g., all amounts deferred with respect to a participant that consist of certain in-kind benefits and/or reimbursements of expenses, as determined in accordance with the regulations; ◆ Split-Dollar Life Insurance Arrangements — e.g., all amounts deferred with respect to a participant under all arrangements sponsored by a service recipient that are subject to the final Treasury regulations governing taxation of split-dollar life insurance;

“PLAN AGGREGATION RULES” (CONT.)

Issue	Provisions in the Regulations
<p>General Categories of “Plans” (Cont.)</p>	<ul style="list-style-type: none"> ◆ Foreign Plans — e.g., all amounts deferred with respect to a participant that would be treated as “modified foreign earned income” under the Internal Revenue Code, as determined in accordance with the regulations; ◆ Stock Rights — e.g., all amounts deferred with respect to a participant under all arrangements sponsored by a service recipient that fall within the definition of “stock rights” in the regulations; and ◆ Other Compensation Arrangements — e.g., all amounts deferred with respect to a participant under all arrangements that do not fall within one of the other categories listed above.
<p>Application of “Plan Aggregation Rules” to Arrangements for an Individual who is Both an Employee and an Independent Contractor</p>	<p>In general, arrangements in which a service provider participates as an employee are <u>not</u> aggregated with arrangements in which the service provider participates as an independent contractor. Where an employee is also on the board of directors of the employer, the arrangements under which the employee participates as a director are not aggregated with any arrangements that director may participate in as an employee, provided that the director arrangements are substantially similar to arrangements provided to non-employee directors.</p>

VI. STATUTORY EFFECTIVE DATE AND GRANDFATHERED AMOUNTS

When an Amount is Considered “Deferred” for §409A

The requirements of §409A generally apply to any amounts deferred into a nonqualified deferred compensation plan on or after January 1, 2005. The regulations provide that an amount is considered deferred before January 1, 2005 if prior to that date (i) the participant had a legally binding right to be paid the amount, and (ii) the right to the amount was earned and vested. The table below summarizes the factors to consider in determining whether an amount is considered deferred before January 1, 2005 and therefore eligible for “grandfathering.”

GUIDANCE TO DETERMINE WHETHER AN AMOUNT WAS DEFERRED BEFORE JANUARY 1, 2005

Issue	Provisions in the Regulations
Legally Binding Right	An amount to which a participant did not have a “legally binding right” before January 1, 2005 will not be considered deferred before January 1, 2005. The regulations indicate that a participant would not have had a legally binding right to payment before January 1, 2005 to the extent that the employer retained discretion to reduce the amount.
Earned and Vested	<p>An amount that was not “earned and vested” before January 1, 2005 will not be considered deferred before January 1, 2005. The regulations provide that a right to an amount is earned and vested <u>only if</u> the amount is not subject to either a <u>substantial risk of forfeiture</u> (as defined in Treasury Regulation §1.83-3(c)) or a <u>requirement to perform further services</u>. As a result, examples of amounts subject to 409A, include:</p> <ul style="list-style-type: none"> ◆ Certain Deferrals of Bonuses Earned in 2004 – The deferral of a bonus earned in 2004 (and otherwise payable in 2005) is subject to §409A if the employer’s bonus program required the participant to be employed on a payment date occurring after December 31, 2004, in order to be eligible to receive the bonus payment. ◆ Unvested Employer Contributions – Employer contributions credited to a participant’s account on or before December 31, 2004, which were unvested as of December 31, 2004, are subject to §409A. <p>The regulations also provide that stock rights, stock appreciation rights or similar compensation will be treated as earned and vested before January 1, 2005 if the rights were either immediately exercisable for cash or substantially vested property on or before December 31, 2004.</p>

STATUTORY EFFECTIVE DATE AND GRANDFATHERED AMOUNTS

Determination of Grandfathered Amounts

The regulations provide additional guidance for determining the grandfathered amount for certain types of plans, as summarized in the table below.

DETERMINATION OF GRANDFATHERED AMOUNTS

Issue	Provisions in the Regulations
Account Balance Plans	<p>The regulations provide that for account balance plans (defined by reference to the FICA regulations), such as voluntary deferred compensation plans or defined contribution supplemental executive retirement plans, the grandfathered amount generally will equal the vested account balance as of December 31, 2004, plus any existing or future earnings attributable to such amounts.</p>
Nonaccount Balance Plans	<p>The regulations provide that for nonaccount balance plans (defined by reference to the FICA regulations), such as defined benefit SERPs, the grandfathered amount is determined as follows:</p> <ul style="list-style-type: none"> ◆ The present value as of December 31, 2004, 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 the payment was in the form with the maximum value. <p>The regulations also clarify that grandfathered amounts may increase in subsequent years to equal the present value of the benefit the service provider <u>actually becomes entitled to</u>, in the form and at the time <u>actually paid</u>, determined under the terms of the plan (including applicable limits under the Code) 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).</p> <p>The regulations require the use of “reasonable actuarial assumptions and methods” in calculating the present value of a benefit under a nonaccount balance plan for purposes of determining the grandfathered amount. Whether assumptions and methods are reasonable for this purpose is determined as of each date the benefit is valued, provided, however, 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 for purposes of calculating the grandfathered benefit.</p>
Equity-Based Compensation	<p>For “equity-based compensation plans,” the determination of the grandfathered amount follows the rules provided above for account balance plans, 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, excluding any exercise price or other amount that must be paid by the service provider.</p>

Material Modification

§409A generally provides that amounts deferred under a plan prior to January 1, 2005 will be eligible for grandfathering unless a “material modification” is made to the plan after October 3, 2004 with respect to such deferrals. The regulations provide that a “material modification” to a plan would occur if a benefit or right existing as of October 3, 2004 is materially enhanced or a new benefit or right is added, and the material enhancement or addition affects amounts earned and vested before January 1, 2005. A material modification can occur pursuant to an amendment to the plan or merely by the employer’s exercise of discretion under the terms of the plan. Furthermore, a material modification may occur even if the added or enhanced benefit would be permitted under §409A. Conversely, the reduction of an existing benefit or right is not a material modification.

The regulations provide additional guidance regarding actions that would be considered a material modification of amounts deferred prior to January 1, 2005, as discussed more fully below.

GUIDANCE ON MATERIAL MODIFICATION

Issue	Provisions in the Regulations
<p>Rescission of a Modification is Permitted (“No Harm, No Foul” Rule)</p>	<p>The regulations provide that an employer may rescind a modification in limited circumstances (i.e., an employer may take action to undo a modification that would inadvertently result in treatment as a “material modification” for purposes of §409A), provided that the rescission occurs by the <u>earlier of</u>:</p> <ul style="list-style-type: none"> (i) the date before any additional right granted by the modification is exercised by the participant (if the change grants a discretionary right), or (ii) the last day of the participant’s taxable year during which the modification occurred.
<p>“Plan Aggregation Rules” Do Not Apply</p>	<p>The “plan aggregation rules” of §409A do <u>not</u> apply to material modifications; therefore, a material modification of one plan would not necessarily result in the material modification of all other similar plans maintained by the plan sponsor for the participant.</p>
<p>Examples of Material Modifications</p>	<p>The regulations indicate that any of the following actions would be a “material modification” to amounts that otherwise would be grandfathered:</p> <ul style="list-style-type: none"> ◆ The addition of a “haircut” provision to an existing plan with respect to grandfathered amounts. ◆ The employer’s exercise of discretion to accelerate vesting to a date <u>on or before December 31, 2004</u> even if the plan provides for such discretion. ◆ The addition of a hardship provision (i.e., right to payment upon an unforeseeable emergency). ◆ Changing (or adding to) the notional investments available under an account balance plan to include an investment measure that does <u>not</u> qualify as a “predetermined actual investment” (as defined in the FICA regulations). ◆ Amending a plan to provide participants an election to terminate participation in a plan (other than pursuant to certain limited transition relief provided under Notice 2005-1).

GUIDANCE ON MATERIAL MODIFICATION (CONT.)

Issue	Provisions in the Regulations
<p>Examples of Actions That Would NOT Be “Material Modifications”</p>	<p>The regulations indicate that the following actions would <u>not</u> be “material modifications” to amounts that otherwise would be grandfathered:</p> <ul style="list-style-type: none"> ◆ Changing (or adding to) the notional investments available under a plan to include an investment measure that qualifies as a “predetermined actual investment” (as defined in the FICA regulations) or reflects a reasonable rate of interest for any given taxable year (as defined in the FICA regulations). ◆ Establishing or contributing to a trust, including additional contributions to an existing trust, from which benefits are to be paid (provided that the contribution to the trust would not otherwise cause an amount to be includible in the service provider’s gross income). ◆ The removal of a “haircut” provision. ◆ Amending an arrangement with respect to amounts deferred after December 31, 2004, to bring the arrangement into compliance with the requirements of §409A. ◆ A cessation of deferrals or termination of a plan under the provisions of a plan. ◆ The exercise of employer discretion over the time and manner of payment to the extent provided under the terms of the plan as of October 3, 2004. ◆ The exercise by a participant of a right permitted under the plan in effect as of October 3, 2004. ◆ Modifying a provision under a grandfathered plan that previously required immediate cancellation of a participant’s current deferral elections in connection with the exercise of a right available under the plan (e.g., a “haircut” distribution), to instead provide that the cancellation will begin as of the first date on which such a cancellation would not violate the requirements of §409A, provided that the length of time for which such a cancellation will apply (once it becomes effective) is the same length as was required prior to the modification. ◆ Complying with a domestic relations order with respect to payments to an individual other than the plan participant, or amending a plan to require compliance with a domestic relations order with respect to payments to an individual other than the plan participant. ◆ Modifying, extending or renewing a stock right, provided that such action would not be treated as the grant of a new stock right under the regulations, and would not result in the stock right being treated under the regulations as having had a deferral feature from the date of grant. ◆ Modifying a plan providing a life annuity form of payment to permit an election between the existing life annuity form of payment and other actuarially equivalent forms of annuity payments that would be treated as a single form of payment with the existing life annuity form of payment under the regulations. ◆ Modifying a grandfathered plan to add a limited cashout feature that is consistent with the regulations.

VII. §409A REPORTING REQUIREMENTS

Reporting of Amounts Deferred Under a Plan that is Subject to §409A

§409A generally requires that plan sponsors report on Form W-2 (for employees) and Form 1099-MISC (for non-employees) all amounts deferred under a nonqualified deferred compensation plan during the year (plus earnings for that year). In December 2005, the IRS suspended these reporting requirements for the 2005 calendar year. Notice 2006-100 (released by the IRS on November 30, 2006) further suspended these reporting requirements for amounts deferred during the 2006 calendar year under a nonqualified deferred compensation plan that has been operated in compliance with the requirements of §409A.

The regulations do not address the reporting requirements for amounts deferred under a nonqualified deferred compensation plan; however, additional guidance is anticipated that will address this topic.

Reporting and Withholding of Amounts Includible in Income Due to a §409A Violation

For any amounts includible in gross income due to the failure of the plan to comply with the requirements of §409A (i.e., a §409A violation), the plan sponsor is required to report such amounts on Form W-2 (for employees) and Form 1099-MISC (for non-employees). In addition, any amounts includible in gross income of an employee due to a §409A violation are considered “wages” for withholding purposes and also must be reported as such on the plan sponsor’s Form 941. In December 2005, the IRS suspended these reporting requirements for the 2005 calendar year. However, Notice 2006-100 (released by the IRS on November 30, 2006) required that any amounts includible in gross income during 2005 or 2006 due to the failure of the plan to comply with §409A be reported on the appropriate form (i.e., Form W-2 for employees and Form 1099-MISC for non-employees). To assist plan sponsors in satisfying this requirement, the Notice also included interim guidance on the reporting and withholding requirements for these amounts.

The regulations do not address the reporting and withholding requirements for amounts includible in income due to a §409A violation; however, additional guidance is anticipated that will further address this topic.

VIII. RELIEF FOR NQDC PLANS LINKED TO QUALIFIED PLAN BENEFITS

Overview

In general, a nonqualified deferred compensation plan (referred to below as an “NQDC plan”) that is linked to a qualified plan may violate the terms of §409A if a change in the qualified plan would cause the amount deferred in the NQDC plan to increase (in effect, an untimely deferral election) or cause the amount deferred in the NQDC plan to decrease (essentially, an impermissible acceleration). The regulations provide limited circumstances under which NQDC plans may be linked to qualified plans without violating the timing rules for deferral elections or the anti-acceleration rules of §409A. The regulations also provide similar relief with respect to NQDC plans linked to certain broad-based foreign retirement plans.

NQDC Plans Linked to Qualified Plan Benefits

The table below summarizes the relief provided in the regulations for NQDC plans linked to qualified plan benefits.

SUMMARY OF RELIEF FOR NQDC PLANS LINKED TO QUALIFIED PLAN BENEFITS

Issue	Provisions in the Regulations
<p>How can an NQDC Plan be Permissibly Linked to a Qualified Plan?</p>	<p>If the amount deferred under the terms of the NQDC plan is determined under a qualified plan’s benefit formula applied without regard to one or more limitations under the Internal Revenue Code (“Code”) or determined as an amount offset by some or all of the benefits provided under a qualified plan, the operation of the qualified plan with respect to changes in benefit limitations under the Code does <u>not</u> constitute either an untimely deferral election or an acceleration of payment under §409A, provided that (i) such operation does not otherwise result in a change in the time or form of payment under the NQDC plan, and (ii) the change in the amounts deferred under the NQDC plan does not exceed the change in the amounts deferred under the qualified plan.</p>
<p>Actions/Inaction in a Qualified Plan that do not result in an Untimely Deferral Election or Acceleration of Payment in an NQDC Plan</p>	<p>The following actions or inactions in a qualified plan will <u>not</u> violate the anti-acceleration rules of §409A or the timing rules for deferral elections, provided that such actions or inactions do not otherwise result in a change in the time or form of payment under the NQDC plan:</p> <ul style="list-style-type: none"> ◆ <u>Increase/Decrease in Benefits by Amendment:</u> <ul style="list-style-type: none"> ⇒ An amendment to freeze or limit future accruals of benefits under the qualified plan (which would increase benefits under the NQDC plan) is not a deferral election, and ⇒ An amendment to increase benefits under the qualified plan (which would decrease benefits under the NQDC plan) is not an acceleration of payment. ◆ <u>Increase/Decrease in Subsidized Benefit or Ancillary Benefit:</u> The addition or removal of a subsidized benefit or ancillary benefit under the qualified plan, or a service provider’s action or inaction with respect to an election to receive a subsidized benefit or ancillary benefit under the qualified plan, is not a deferral election or an acceleration of payment. <p><i>Clark Consulting Note:</i> The change in the amount deferred under the NQDC plan due to the actions or inactions described above cannot exceed the change in the amount deferred under the qualified plan.</p>

SUMMARY OF RELIEF FOR NQDC PLANS LINKED TO QUALIFIED PLAN BENEFITS (CONT.)

Issue	Provisions in the Regulations
<p>Actions/Inactions in a §401(k) or Similar Type of Qualified Plan that do not result in an Untimely Deferral Election or Acceleration of Payment in an NQDC Plan</p>	<ul style="list-style-type: none"> ◆ Change in Elective Deferral Amounts: The service provider’s action or inaction under a qualified plan (e.g., a §401(k) plan) with respect to elective deferrals and certain other employee pre-tax contributions, such as an adjustment to a deferral election under the qualified plan, is <u>not</u>: <ul style="list-style-type: none"> ⇒ an untimely <u>deferral election</u> under the NQDC plan, even if such operation results in an increase of amounts deferred under the NQDC plan, provided that, for any given calendar year, the service provider’s actions or inactions <u>do not result in an increase</u> in the amounts deferred under all NQDC plans in which the service provider participates (<u>excluding</u> certain matching or contingent amounts credited to the NQDC plans in accordance with the regulations) <u>in excess of the IRC §402(g) limit</u> applicable to elective deferrals in effect for the year; or ⇒ an <u>acceleration of payment</u> under the NQDC plan, even if such operation results in a decrease in amounts deferred under the NQDC plan, provided that, for any given calendar year, the service provider’s actions or inactions <u>do not result in a decrease</u> in the amounts deferred under all NQDC plans in which the service provider participates (<u>excluding</u> certain matching or contingent amounts credited to the NQDC plans in accordance with the regulations) <u>in excess of the IRC §402(g) limit</u> in effect for the year. <p><i>Clark Consulting Note:</i> For purposes of applying the rules above, the applicable IRC §402(g) limit in effect for the year includes the increased limit for catch-up contributions if the employee is eligible for such contributions. For 2007, this limit is \$15,500 and the additional limit for catch-up contributions for individuals aged 50 or over is \$5,000.</p> ◆ Change in Matching Contributions or other Contingent Contributions. The service provider’s action or inaction under a qualified plan with respect to elective deferrals, certain other employee pre-tax contributions, and employee after-tax contributions that affects the amounts that are credited under an NQDC plan as matching contributions or other contingent contributions, is <u>not</u>: <ul style="list-style-type: none"> ⇒ <u>an untimely deferral election or an acceleration of payment</u> under the NQDC plan, provided that, for any given calendar year, the total of such matching or contingent amounts <u>never exceeds 100%</u> of the matching or contingent amounts that would have been provided under the employer’s qualified plan absent the restrictions in the qualified plan intended to reflect the applicable Internal Revenue Code limits on qualified plan contributions (e.g., IRC §401(a)(17) and IRC §401(m)) in effect for the year.

IX. GUIDANCE ON WHETHER CERTAIN ARRANGEMENTS ARE BEYOND THE SCOPE OF §409A

Overview

The requirements of §409A generally apply to any amounts deferred into a nonqualified deferred compensation plan on or after January 1, 2005. The term “nonqualified deferred compensation plan” is broadly defined in §409A as any plan or arrangement that provides for the “deferral of compensation,” subject to certain limited exceptions. In general, a plan provides for the “deferral of compensation” if, under the terms of the plan and the relevant facts and circumstances, the participant 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 participant in a later taxable year.

The regulations provide guidance describing which arrangements are excluded from §409A, and address the circumstances under which §409A applies to specific arrangements, such as severance plans, stock options and stock appreciation rights, and arrangements with independent contractors.

Short -Term Deferrals

In general, an arrangement that only provides for “short-term deferrals” is not subject to §409A. The regulations provide guidance on what is required for an arrangement to fall within this exception, as summarized below.

“SHORT-TERM DEFERRALS”

Issue	Provisions in the Regulations
<p>Determining Whether an Arrangement Provides for “Short-Term Deferrals”</p>	<p>Under the regulations, an arrangement provides for “short-term deferrals” and is therefore excluded from the scope of §409A if the arrangement satisfies the following requirements: (i) the arrangement does not provide for a “deferred payment;” and (ii) the participant actually or constructively receives the payment under the arrangement on or before the end of the “applicable 2 ½ month period.”</p> <p>Guidance provided in the regulations to determine whether an arrangement satisfies these requirements includes:</p> <ul style="list-style-type: none"> ◆ When an Arrangement is Deemed to Provide for a “Deferred Payment.” A plan provides for a “deferred payment” if a payment may be made or completed after a date or event that will (<u>or may</u>) occur after the end of the “applicable 2 ½ month period.” As a result, an arrangement would be deemed to provide for a “deferred payment” and therefore would <u>not</u> qualify for the “short-term deferral” exception to §409A if a payment <i>could</i> occur after the “applicable 2 ½ month period,” <u>even if</u> the amount is <i>actually</i> paid within the “applicable 2 ½ month period.” ◆ Identifying the “Applicable 2 ½ Month Period.” The regulations generally define the applicable “applicable 2 ½ month period” as the 15th day of the third month following <u>the later of</u> the end of the participant’s or employer’s first taxable year in which the right to the payment is <u>no longer subject to a substantial risk of forfeiture</u> (i.e., has become vested). In determining the “applicable 2 ½ month period” for amounts that were never subject to a risk of forfeiture, the regulations provide that the amounts will be treated as no longer subject to a substantial risk of forfeiture on the first date the participant obtains a legally binding right to the payment. <p><i>Clark Consulting Note:</i> Under limited circumstances set forth in the regulations (described below) payments that are delayed beyond the “applicable 2½ month period” may <u>continue to qualify</u> as a “short-term deferral.”</p>

“SHORT-TERM DEFERRALS” (CONT.)

Issue	Provisions in the Regulations
<p>Determining Whether an Arrangement Provides for “Short-Term Deferrals” (Cont.)</p>	<p>◆ Deadline for Payment Not Required to be in Writing. An arrangement is <u>not</u> required to provide in writing that payment must be made by the short-term deferral deadline (i.e., the “applicable 2 ½ month period”) in order to qualify for the “short-term deferral” exception. However, if the payment of an amount is not made by the applicable short-term deferral deadline (i.e., the amount becomes subject to §409A) and the arrangement does not specify the payment date for such amount in writing, the arrangement would be in violation of the requirement in the §409A regulations that the payment terms (e.g., the payment date, the permissible distribution events, etc.) must be in writing.</p> <p>Example – Arrangement that Provides for “Short-Term Deferrals”: Under an employer’s bonus program, an employee will be awarded an annual bonus for services performed between January 1, 2009 and December 31, 2009, provided that the employee continues to perform services through the scheduled payment date of February 15, 2010. The bonus will qualify as a “short-term deferral” (and will therefore be excluded from §409A), provided that it is paid no later than 2 ½ months following the end of the calendar year in which the compensation becomes vested (i.e., no later than March 15, 2011).</p> <p>Example – Arrangement that Does NOT Provide for “Short-Term Deferrals”: On November 1, 2008, an employee is awarded a bonus, which is not subject to a risk of forfeiture. The arrangement provides that payment of the bonus will be made in a lump sum following the employee’s separation from service. Because the separation from service is an event that <u>may occur</u> after the “applicable 2 ½ month period,” the arrangement is deemed to provide for a deferral of compensation (and therefore will not qualify for the “short-term deferral” exclusion from §409A) <u>even if</u> the employee separates from service and the bonus is actually paid within the “applicable 2 ½ month period.”</p>
<p>Certain Delayed Payments May Continue to Qualify as “Short-Term Deferrals”</p>	<p>The regulations provide limited circumstances under which payments that are delayed beyond the “applicable 2½ month period” may <u>continue to qualify</u> as “short-term deferrals.” This guidance is described below.</p> <p>◆ Amounts that Would Not be Deductible Due to Application of IRC §162(m). A payment made after the “applicable 2½ month period” may continue to qualify as a “short-term deferral” if it is established that: (i) the employer reasonably anticipated the employer’s deduction with respect to such payment otherwise would not be permitted by application of §162(m), (ii) as of the date the legally binding right to the payment arose, a reasonable person would not have anticipated the application of §162(m) at the time of the payment, <u>and</u> (iii) the payment is made as soon as reasonably practicable following the first date on which the employer reasonably anticipates or reasonably should anticipate that, if the payment were made on such date, the employer’s deduction with respect to such payment would no longer be restricted due to the application of §162(m).</p> <p>◆ Delay Due to Unforeseeable Events. A payment made after the “applicable 2½ month period” may continue to qualify as a “short-term deferral” if it is established that (i) it was administratively impracticable to make the payment before the close of such period, and (ii) as of the date on which the legally binding right to the compensation arose, such impracticability was unforeseeable, provided that the payment is made as soon as administratively practicable.</p> <p>◆ Delay Where Payment Would Jeopardize Ability to Continue as a Going Concern. A payment made after the “applicable 2½ month period” may continue to qualify as a “short-term deferral” if it is established that making the payment by the end of the “applicable 2 ½ month period” would have jeopardized the ability of the employer to continue as a going concern, provided that the payment is made as soon as the payment would no longer have such effect.</p>

GUIDANCE ON WHETHER CERTAIN ARRANGEMENTS ARE BEYOND THE SCOPE OF §409A

Separation Pay Arrangements

Severance pay arrangements (referred to in the regulations as “separation pay” arrangements) are not categorically excluded from §409A. However, the regulations do provide limited exceptions from §409A for certain types of separation pay arrangements, as described below.

GUIDANCE ON APPLICATION OF §409A TO SEPARATION PAY ARRANGEMENTS

Issue	Provisions in the Regulations
Separation Pay is Generally Subject to §409A	Except as provided in the regulations (e.g., the exception for “short-term deferrals” or the exclusions for certain separation pay described below), an arrangement that provides for a “deferral of compensation” is generally subject to §409A, even when the right to payment of the compensation is conditioned upon a separation of service.
Separation Pay Cannot be Used to Avoid §409A	Any payment or benefit that acts as a substitute for, or replacement of, amounts deferred under a nonqualified deferred compensation plan will <u>not</u> be excluded from coverage under §409A and will be treated as a payment of the amounts under the nonqualified deferred compensation plan rather than as a payment under the separation pay arrangement. In other words, the separation pay arrangement cannot be used to circumvent the application of §409A.
Certain Involuntary Separation Pay Arrangements and Window Programs Excluded from §409A	<p>Certain involuntary separation pay arrangements or window programs (i.e., programs offered for a limited period of time to plan participants who separate from service during a set period, no greater than one year) that satisfy the requirements described below are deemed to not provide for a “deferral of compensation” and, therefore, are <u>excluded</u> from §409A.</p> <ul style="list-style-type: none"> ◆ <u>Limitation on Amount and Timing of Payment.</u> This exclusion from §409A is available to the extent the amount and timing of the payments fall within the following limits: <ul style="list-style-type: none"> • Amount of Payments - The amount of payments does not exceed <u>the lesser of</u>: <ul style="list-style-type: none"> ⇒ Two times the participant’s annualized compensation, determined based upon the participant’s annual rate of pay for services performed during the calendar year preceding the calendar year in which the separation from service occurs (adjusted for any increase in rate of pay to the participant that was expected to continue indefinitely if the participant had not separated from service); <u>or</u> ⇒ Two times the maximum amount of “compensation” that may be taken into account under the IRC §401(a)(17) limit in effect for the year in which the separation from service occurs (<i>Note: 2 x \$225,000 for 2007</i>); and • Timing of Payments – The plan provides that the payments are required to be made <u>no later than</u> the end of the second calendar year following the year of separation. ◆ <u>Treatment of Payments that Exceed the Limitation on Amount.</u> Where an employee is entitled to a payment that otherwise qualifies for the involuntary separation pay exception from §409A described above, except that the payment exceeds the limitation on amount, the regulations clarify that <u>only</u> the portion of the payment in excess of the limit will be subject to §409A. As a result, the right to the portion of the payment <u>up to</u> the applicable limit will <u>not</u> be subject to §409A, provided that the payment of such amount is required to be made, and is made, no later than the end of the second calendar year following the year of separation. <p><i>Clark Consulting Note:</i> Under limited circumstances set forth in the regulations (described below), an employee’s voluntary separation for “good reason” will be treated as an involuntary separation from service (i.e., the arrangement may qualify for the exclusion from §409A for involuntary separation pay, provided the requirements above are satisfied).</p>

GUIDANCE ON WHETHER CERTAIN ARRANGEMENTS ARE BEYOND THE SCOPE OF §409A

GUIDANCE ON APPLICATION OF §409A TO SEPARATION PAY ARRANGEMENTS (CONT.)

Issue	Provisions in the Regulations
<p>When can Voluntary Termination for “Good Reason” be Treated as an Involuntary Separation</p>	<ul style="list-style-type: none"> ◆ <u>General Requirements for a Voluntary Termination to be Treated as an Involuntary Separation.</u> The regulations clarify that an employee’s voluntary separation from service under certain bona fide conditions (i.e., “good reason”) will be treated as an involuntary separation from service, provided that (i) the avoidance of the requirements of §409A is not a purpose of the conditions in the plan or the actions by the employer, and (ii) the voluntary separation from service under such conditions effectively constitutes an involuntary separation from service. In addition, the “good reason” condition(s) must be defined in the plan to require actions taken by the employer that result in a <u>material negative change</u> to the employee, such as duties to be performed or the conditions under which such duties are to be performed. ◆ <u>“Safe Harbor” Rule for Determining When a “Good Reason” Termination can be Treated as an Involuntary Separation.</u> The regulations provide that a voluntary separation from service for “good reason” that satisfies the following conditions will be deemed to be an involuntary separation for purposes of §409A (provided the conditions are set forth in the plan): <ul style="list-style-type: none"> • The separation from service must occur during a pre-determined period of time (<u>not to exceed two years</u>) following the initial existence of <u>one or more</u> of the following conditions: <ul style="list-style-type: none"> ⇒ A material diminution in the employee’s base compensation; ⇒ A material diminution in the employee’s authority, duties or responsibilities; ⇒ A material diminution in the authority, duties or responsibilities of the supervisor to whom the employee is required to report; ⇒ A material diminution in the budget over which the employee retains authority; ⇒ A material change in the geographic location at which the employee must perform the services; ⇒ Any other action or inaction that constitutes a material breach by the employer of the agreement under which the employee provides services. • The amount, time and form of payment due upon the separation from service must be <u>substantially identical</u> to the amount, time and form of payment payable due to an actual involuntary separation from service, to the extent such a right exists. • The employee must be required to provide notice of the existence of the applicable condition(s) within a period <u>not to exceed 90 days</u> of the initial existence of the condition. • The employee must be provided a period of <u>at least 30 days</u> following the employee’s notice during which it may remedy the condition and not be required to pay the amount.

GUIDANCE ON WHETHER CERTAIN ARRANGEMENTS ARE BEYOND THE SCOPE OF §409A

GUIDANCE ON APPLICATION OF §409A TO SEPARATION PAY ARRANGEMENTS (CONT.)

Issue	Provisions in the Regulations
Other Forms of Separation Pay Excluded from §409A	<p>Other forms of separation pay that are <u>excluded</u> from §409A, include:</p> <ul style="list-style-type: none"> ◆ Limited Payments. Payments of separation pay that in the aggregate do not exceed the limit under IRC §402(g)(1)(B) in effect for the year in which the separation from service occurs. (<i>Note: \$15,500 in 2007.</i>) ◆ Certain Reimbursements. Reimbursement for certain reasonable business expenses, reasonable outplacement expenses and reasonable moving expenses actually incurred and directly related to the termination of services may be provided for a limited period of time. In addition, reimbursements of medical expenses incurred and allowable as a deduction under §213 are excluded from §409A to the extent such reimbursement rights only apply during the period of time during which the participant would be entitled to continuation coverage under COBRA (§4980B) if the participant elected such coverage and paid the applicable premiums. ◆ Collectively Bargained Separation Pay Arrangements. ◆ Foreign Separation Pay Plans. These plans are excluded from §409A to the extent the plan provides for amounts of separation pay required to be provided under the applicable law of a foreign jurisdiction.

Arrangements with Independent Contractors

The regulations provide guidance on the application of §409A to arrangements involving independent contractors, as described below.

GUIDANCE ON APPLICATION OF §409A TO ARRANGEMENTS WITH INDEPENDENT CONTRACTORS

Issue	Provisions in the Regulations
Independent Contractors	<p>Certain arrangements between a plan sponsor and an <u>unrelated</u> independent contractor (other than a director or provider of management services) are excluded from coverage under §409A if the independent contractor provides “significant services” to <u>two or more unrelated</u> service recipients during the taxable year of the deferral. An independent contractor will be considered to have provided “significant services” to two or more service recipients if not more than <u>70%</u> of the total annual revenue generated is derived from any particular employer or group of related employers.</p> <p>Additional guidance provided in the regulations includes the following:</p> <ul style="list-style-type: none"> ◆ Arrangements with Directors. Directors are <u>not</u> excluded from coverage under §409A. ◆ Management Services. Where an independent contractor is providing “management services” (as defined in the regulations), such services are not considered unrelated and therefore the arrangement is subject to §409A. ◆ “Plan Aggregation” Rules. In general, arrangements in which a service provider participates as an employee are <u>not</u> aggregated with arrangements in which the service provider participates as an independent contractor (i.e., the arrangements are treated as separate “plans”). Where an employee is also on the board of directors of the employer, the arrangements under which the employee participates as a director are not aggregated with any arrangements that director may participate in as an employee, provided that the director arrangements are substantially similar to arrangements provided to non-employee directors.

GUIDANCE ON WHETHER CERTAIN ARRANGEMENTS ARE BEYOND THE SCOPE OF §409A

Stock Options and Stock Appreciation Rights

The regulations generally provide that stock options and stock appreciation rights (SARs) for employer stock issued at an exercise price at least equal to fair market value on the date of grant are excluded from coverage under §409A. However, note that if the stock right contains a feature for deferral of compensation, the stock right will be subject to §409A, as described below.

GUIDANCE ON APPLICATION OF §409A TO STOCK OPTIONS AND STOCK APPRECIATION RIGHTS (SARS)

Issue	Provisions in the Regulations
<p>Nonstatutory Stock Options and SARs; Generally</p>	<p>Nonstatutory stock options and SARs on employer stock are excluded from coverage under §409A where:</p> <ul style="list-style-type: none"> ◆ The exercise price is <u>not less than</u> the fair market value of the underlying equity on the date of grant; ◆ The number of shares subject to the arrangement is <u>fixed</u> at the date of grant; ◆ The arrangement does <u>not</u> include any feature for the deferral of compensation, other than: <ul style="list-style-type: none"> • For stock options, income may not be deferred beyond the later of the exercise or disposition of the option or the time the stock acquired pursuant to the option first becomes substantially vested; and • For SARs, income may not be deferred beyond the exercise of the SAR; ◆ For SARs, the compensation <u>cannot be greater than</u> the excess of the fair market value of the stock on the date the SAR is exercised over an amount specified on the date of grant; and ◆ The underlying stock must relate to “service recipient stock” (generally defined to include any class of common stock under IRC §305 of the employer or other “eligible issuer,” and may include ADRs). <p><i>Clark Consulting Note:</i> The ability to defer compensation beyond the exercise date under a stock option or a SAR constitutes an “additional deferral feature,” which may impact whether the underlying equity program is subject to the requirements of §409A. For example, a stock right with a deferral feature is subject to §409A from the date of grant. As a result, to comply with §409A, the stock right would be required to specify a permissible time and form of payment, which would significantly change the nature of the arrangement. Where a deferral feature is added to an existing stock option or SAR, the stock right generally would violate §409A because it would be subject to the requirements of §409A from the date of grant but would typically have failed to specify a permissible payment time or event if designed in the traditional manner.</p>
<p>Statutory Stock Options</p>	<p>In general, the regulations provide that incentive stock options described under IRC §422 and options granted under an employee stock purchase plan described under IRC §423 are excluded from §409A. However, if there is a modification, extension or renewal of a statutory option that would be treated as the grant of a new, nonstatutory option under the Internal Revenue Code, the regulations provide that the option will be treated as if it had been <u>a nonstatutory stock option from the date of the original grant</u> — i.e., the determination of whether the option is subject to §409A would be determined in accordance with the requirements applicable to nonstatutory stock options described above.</p>

GUIDANCE ON WHETHER CERTAIN ARRANGEMENTS ARE BEYOND THE SCOPE OF §409A

GUIDANCE ON APPLICATION OF §409A TO STOCK OPTIONS AND STOCK APPRECIATION RIGHTS (SARS)

Issue	Provisions in the Regulations
Treatment of Dividend Rights	<p>The regulations provide that a right to receive dividend equivalents that is <u>contingent</u> upon the exercise of the stock right will be treated as a <u>reduction in the exercise price</u> of the stock right, which generally will cause the stock right to be considered deferred compensation and subject to §409A. However, a right to receive dividend equivalents that is <u>not</u> contingent upon the exercise of the stock right may be treated as a separate arrangement from the underlying stock right — i.e., will not affect whether the related stock right qualifies for exclusion from §409A. In such case, the separate arrangement for the right to such dividend equivalents generally must comply with the requirements of §409A unless it independently qualifies for exemption from §409A (e.g., the arrangement provides for a “short-term deferral”).</p>
Modifications and Extensions of a Stock Right	<p>In general, any modification (e.g., direct or indirect reduction in the exercise price) of a stock right is treated as a new grant that may affect its exclusion from §409A. However, the regulations provide that a change in the terms of a stock right that shortens the exercise period of the stock right will not be treated as a “modification” to the stock right for §409A purposes.</p> <p>Subject to the exceptions described below, if there is an <u>extension of the exercise period</u> of a stock right, the stock right is treated as having had an “additional deferral feature” (and therefore will be subject to §409A) from the original date of grant of the stock right.</p> <p>◆ Certain Extensions are Not Treated as “Additional Deferral Features.” An extension of the term of a stock right will not be treated as an “additional deferral feature” under the following circumstances:</p> <ul style="list-style-type: none"> • If the exercise period is not extended beyond the <u>earlier of</u> (i) the latest date upon which the stock right could have expired by its original terms, or (ii) the 10th anniversary of the original date of grant of the stock right; or • If the exercise period of a stock right is extended at a time when the exercise price of the stock right equals or exceeds (i) the fair market value of the service recipient stock that could be purchased (e.g., an “underwater” option), or (ii) the fair market value of the service recipient stock used to determine payment to the participant (e.g., an “underwater” SAR).

Split-Dollar Life Insurance Arrangements

The preamble to the regulations indicates that the determination of whether a split-dollar life insurance arrangement provides for a “deferral of compensation” (and is therefore subject to §409A) must be determined through application of the general rules of §409A, but the regulations themselves do not expressly address this topic.

However, on April 10, 2007, the IRS released Notice 2007-34, which provides guidance regarding the application of the general rules of §409A to split-dollar life insurance in order to determine whether the arrangement provides for a “deferral of compensation” and is therefore subject to §409A. To the extent that a split-dollar life insurance arrangement is deemed to be subject to §409A, Notice 2007-34 also describes the circumstances under which the plan sponsor may make changes necessary to bring the arrangement into compliance with §409A without being treated as a “material modification” for purposes of the final Treasury regulations that govern taxation of split-dollar life insurance. Clark Consulting will provide its clients with additional information regarding this issue.