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Major References: [Proposed Regulations Under Code Section 409A](#)

Prior Washington Reports: 05-102; 05-99; 05-97; 05-89; 05-70; 05-59; 05-26; 05-6

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### **SEE THE CIRCULAR 230 DISCLAIMERS APPENDED TO THE CONCLUSION OF THIS WASHINGTON REPORT.**

*As anticipated in our Bulletins Nos. 05-102 and 05-99, respecting the just released proposed regulations under Internal Revenue Code Section 409A -- the new deferred compensation rules, this Washington Report provides a more detailed discussion of those regulations than provided in the earlier Bulletins. The proposed regulations represent the second round of guidance under the new statutory rules and build on the foundation put in place by the first round (Notice 2005-1 which was issued in December 2004). (See our Bulletins Nos. 05-89, 05-70, 05-59, 05-26 and 05-6.)*

## Statutory Overview

The new rules generally apply to any agreement or arrangement that provides for the deferral of compensation (including those covering only one person). Certain tax-favored retirement plans (e.g., qualified retirement plans, 403(b) plans) and bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plans are statutorily excepted from the new rules.

The new rules impose three new key requirements, which must be satisfied both in form and operation: (1) distribution restrictions, (2) acceleration restrictions, and (3) election restrictions. The new requirements are in addition to the existing rules, and do not replace them. As a result, a deferred compensation plan will need to satisfy both the new rules and the existing rules (e.g., constructive receipt, economic benefit and Code section 83 rules, to the extent applicable).

The distribution restrictions provide that deferred compensation cannot be distributed any earlier than one of six specified events - (1) separation from service (for key employees of publicly-traded companies, the deferred compensation must not be distributed for at least six months after separation from service); (2) disability (as narrowly defined in the statute); (3) death; (4) a specified time (or fixed schedule specified under the arrangement as of the date of deferral), but not an event; (5) a change in the ownership or effective control of the corporation or in the ownership of a substantial portion of the assets of the corporation (to the extent provided by the Treasury); or (6) the occurrence of an unforeseeable emergency (as narrowly defined in the statute).

The acceleration restrictions provide that the deferred compensation cannot be accelerated except as otherwise provided in regulations. For example, so-called "haircut" provisions, which allow for the accelerated distribution of deferred compensation if there is a reduction in the amount payable (e.g., a 10% reduction), are no longer permissible.

The election restrictions impose requirements with respect to both the timing of a participant's initial deferral election as well as the designation of the time and form of distributions. A participant's initial deferral election to defer compensation for services performed during a taxable year generally must be made no later than the close of the preceding taxable year. There are two statutory exceptions. First, in the case of a new plan or a participant first becoming eligible under a plan, the initial deferral election generally must be made within 30 days of initial eligibility. Second, the deferral election with respect to "performance-based compensation", which must be defined by the Treasury and the Internal Revenue Service, can be made at least 6 months before the end of the performance period, provided such performance period is at least 12 months.

Under the new rules, the time and form of distributions must be designated at the time of the initial deferral election. However, the new rules allow for changes that further delay or change the form of payment if certain requirements are met (e.g., the change is made at least one year in advance of the originally scheduled payment date and the change delays the originally scheduled payment date at least five years).

Section 409A also imposes new rules regarding funding. For example, assets that are located outside of the United States or that become restricted to the payment of deferred compensation in connection with a change in the employer's financial health would be taxable to the participants when transferred outside of the United States or set aside. In addition, the new rules require all deferred compensation to be reported on IRS Form W-2 or Form 1099 when deferred, even though the compensation may not yet be taxable.

There are significant adverse tax consequences if the new requirements are not satisfied: (1) all deferred compensation must be included in income in the current taxable year to the extent not subject to a substantial risk of forfeiture (including deferrals in prior years); (2) an additional tax equal to the interest, using the IRS' underpayment rate plus 1%, that would have been imposed during the deferral period if the deferred compensation had been includible in income when first deferred (or not subject to a substantial risk of forfeiture); and (3) an additional tax equal to 20% of the deferred compensation.

The new rules statutorily apply to amounts deferred on or after January 1, 2005. Amounts deferred (earned and vested) before January 1, 2005 are not subject to the new rules unless there is a material modification to the arrangement on or after October 3, 2004.

### Proposed Regulations

#### (1) General Effective Date Issues

##### (a) Proposed Effective Date of Regulations:

The regulations are proposed to be generally applicable for taxable years beginning on or after January 1, 2007. The proposed regulations also extend the good faith compliance standard announced in Notice 2005-1 until the end of the 2006 taxable year. Under this extension, between the statutory effective date of the new rules (i.e., January 1, 2005) and the proposed effective date of the regulations (i.e., January 1, 2007), employers are subject to a good faith compliance standard, which is met if the employer operates the plan in good faith compliance with the provisions of Code section 409A and Notice 2005-1. To the extent an issue is not addressed in Notice 2005-1, the plan must follow a good faith, reasonable interpretation of Code section 409A, and, to the extent not inconsistent therewith, the plan's terms. In addition, compliance with the proposed regulations will be considered good faith compliance with the statute (i.e., employers can rely on the proposed regulations).

##### (b) Written Plan Requirements:

The proposed regulations expressly require that the material terms of a plan be set forth in writing. For this purpose, the material terms generally include the amount (or the method or formula for determining the amount) of deferred compensation to be provided under the arrangement and the time when it will be paid. This written plan requirement must generally be satisfied on or before December 31, 2006 for plans established before then.

##### (c) Amendments to Comply with 409A:

The proposed regulations extend the date on which plans must be amended to comply with the requirements of Code section 409A to the end of 2006. However, as discussed above, plans must generally comply in operation under the good faith compliance standard beginning on and after January 1, 2005. In addition, although plans do not have to be amended until the end of 2006, plan sponsors may need to take actions by the end of 2005 to utilize certain transition rules (discussed further below).

#### (2) Plans Subject to the New Rules

##### (a) General:

Code section 409A generally applies to all nonqualified deferred compensation plans, which are defined broadly to include any plan (including those covering only one person) that provides for the deferral of compensation. Certain tax-favored plans, like qualified retirement plans (401(a)) and tax-deferred annuities (403(b)) are statutorily excepted. In addition, bona fide vacation, sick leave, compensatory time, disability pay and death benefit plans are statutorily excepted.

(b) Arrangements with Independent Contractors:

Consistent with Notice 2005-1, the proposed regulations also except from 409A certain arrangements with independent contractors. Specifically, the proposed regulations except amounts deferred pursuant to an arrangement between a service recipient and an unrelated independent contractor (other than a director of a corporation), if during the independent contractor's taxable year in which the amount is deferred, the independent contractor is providing significant services to each of two or more service recipients that are unrelated, both to each other and to the independent contractor. The proposed regulations include two new provisions for determining whether the services are significant, which is generally based on all of the relevant facts and circumstances: (i) the determination is made separately with respect to each trade or business in which the service provider is engaged; and (ii) a safe harbor has been provided under which an independent contractor with multiple unrelated service recipients, to whom the independent contractor also is not related, will be treated as providing significant services to more than one of those service recipients, if not more than 70 percent of the total revenue generated by the trade or business in the particular taxable year is derived from any particular service recipient (or group of related service recipients).

(3) Plans Providing for the Deferral of Compensation(a) Legally Binding Right:

Consistent with Notice 2005-1, the proposed regulations state that a plan provides for the deferral of compensation only if, under its terms and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year. A legally binding right to compensation may exist even where the right is subject to conditions, including conditions that constitute a substantial risk of forfeiture. In contrast, a service provider does not have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated by the service recipient or other person after the services creating the right to the compensation have been performed. The proposed regulations clarify that such negative discretion will be recognized unless it lacks substantive significance or is available or exercisable only upon a condition.

(b) Exceptions and Special Rules:

Consistent with Notice 2005-1, the proposed regulations include a number of exceptions and special rules for purposes of determining whether an arrangement provides for the deferral of compensation, including, but not limited to, the following:

(i) Short-term Deferrals:(A) Exception Extended:

The proposed regulations permanently extend the exception for short-term deferrals provided in Notice 2005-1. Under that Notice a deferral of compensation generally does not occur if an amount is actually or constructively received by the service provider by the later of (A) the date that is 2-1/2 months from the end of the service provider's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture, or (B) the date that is 2-1/2 months from the end of the service recipient's year in which the amount is no longer subject to a substantial risk of forfeiture.

(B) Document Requirements:

The proposed regulations include the important clarification that an arrangement is still within the short-term deferral exception even though it does not provide in writing that the payment must be made by the relevant deadline. Thus, an amount will qualify for the exception if the amount is actually paid out by the appropriate deadline, regardless of whether the terms of the arrangement expressly require it to be paid out by the appropriate deadline. However, there are a number of potential adverse consequences if a specified date is not provided and a number of special rules that apply only if a specified date is designated. For example, if a specified date is not designated and the amount is not actually distributed by the relevant deadline (except due to unforeseeable administrative or solvency issues), the payment will result in automatic violation of Code section 409A due to the failure to specify the payment date or a permissible payment event. In addition, if a specified date is designated, and the payment is not actually made before the relevant deadline, the proposed regulations include special rules which may permit the payment to be made in the same calendar year as the fixed payment date.

(C) Substantial Risk of Forfeiture:

In general, Notice 2005-1 provides that, for purposes of Code section 409A, compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. Notice 2005-1 also provides that this standard is different from the substantial risk of forfeiture standard that may apply under other Code sections (e.g., Code section 83 and 457). For instance, Notice 2005-1 provides that: (I) substantial risks of forfeitures added after the beginning of the period of service to which the compensation relates will not be recognized (i.e., no rolling risks of forfeiture), (II) non-competes will not constitute a substantial risk of forfeiture, and (III) salary deferrals will be considered subject to a substantial risk of forfeiture only if the amount subject to the substantial risk of forfeiture is materially greater than the amount the service recipient could have elected to receive. The proposed regulations generally adopt the same standards prescribed in Notice 2005-1.

(ii) Stock Rights:

The proposed regulations contain special rules for stock options and stock appreciation rights ("SARs"), which are collectively referred to under the regulations as "stock rights."

(A) Stock Options: Consistent with Notice 2005-1, the proposed regulations provide that the grant of an incentive stock option (ISO) under section 422, or the grant of an option under an employee stock purchase plan described in section 423 does not constitute a deferral of compensation. In contrast, the grant of all other types of options, including nonqualified stock options (NSOs), generally does constitute a deferral of compensation unless all of the following requirements are met: (I) the option is for the purchase of service recipient stock, (II) the exercise price can never be less than the fair market value of the underlying stock on the date the option is originally granted, (III) the number of shares subject to the option is fixed on the original grant date, (IV) the transfer or exercise of the option is subject to taxation under Code section 83 and Regulations section 1.83-7, and (V) the option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of exercise or disposition of the option under Regulations section 1.83-7, or the time the stock acquired pursuant

to the exercise of the option first becomes substantially vested (as defined in Regulations section 1.83-3(b)).

(B) SARs:

Notice 2005-1 treats SARs differently from stock options. Notice 2005-1 generally treats SARs as providing for the deferral of compensation, with only two exceptions: (I) for certain SARs involving service recipient stock traded on an established securities market and settled only in the service recipient stock, and (II) for certain SARs granted under programs in effect on or before October 3, 2004. In a significant departure from Notice 2005-1, the proposed regulations essentially treat SARs in the same manner as NSOs described above (and subject to the same requirements to be excepted). This new treatment applies whether or not the underlying stock is traded on an established securities market, and whether or not the SARs are settled in service recipient stock.

(C) Modifications:

The proposed regulations provide that any modification of the terms of a stock right, other than an extension or renewal of the stock right, is considered the granting of a new stock right, which must satisfy the conditions described above at the date of the grant of the new stock right in order to be excepted from the definition of a deferral of compensation. For this purpose, the term "modification" means any change in the terms of the stock right that may provide the holder with a direct or indirect reduction in the exercise price, or an additional deferral feature, or an extension or renewal of the stock right, regardless of whether the holder in fact benefits from the change in terms. The proposed regulations also provide that if a stock right is extended or renewed, the stock right is treated as having had an additional deferral feature from the date of grant. As such, the stock right would not qualify for the exceptions described above, and therefore, would be subject to Code section 409A from the original grant date. In most cases, traditional stock rights would not satisfy the new requirements (e.g., providing a specified payment date). The proposed regulations also provide that the following actions do not constitute modifications: (I) to change the terms of a stock right to shorten the exercise period, (II) to add a feature to allow the holder to tender previously acquired stock to pay the exercise price, (III) to withhold or have withheld stock to facilitate the payment of employment taxes or required withholding taxes from the exercise of the stock right, (IV) for the grantor to exercise discretion specifically reserved under the stock right with respect to the transferability of the stock right, and (V) to accelerate the time at which a stock right may be exercised if the stock right is not immediately exercisable in full. The proposed regulations also provide that the substitution and assumption of stock rights will not be treated as the grant of a new stock right or change in the form of payment if the requirements of Regulations section 1.424-1 are satisfied (subject to certain modifications prescribed in the proposed regulations).

(D) Determining Fair Market Value:

(I) Readily Tradable Stock:

With respect to stock that is readily tradable on an established securities market, the proposed regulations prescribe alternative valuation methods that can be used. For example, fair market value can be determined based upon the last sale before or the first sale after the grant, the closing price on the trading day before or the trading day of the grant, or any other reasonable basis using actual transactions in such stock as reported by the market and consistently applied. The

regulations provide further that fair market value can also be based upon an average selling price during a specified period that is within 30 days before or after the grant.

(II) Not Readily Tradable Stock:

With respect to stock that is not readily tradable, consistent with Notice 2005-1, the proposed regulations generally allow for the use of any reasonable method to determine the fair market value of service recipient stock. The proposed regulations also prescribe specific valuation methodologies that are deemed to be reasonable for this purpose. For example, a valuation of a class of stock determined by an independent appraisal that meets the requirements of Code section 401(a)(28)(C) and the regulations thereunder as of a date that is no more than 12 months before the relevant transaction to which the valuation is applied (e.g., the grant date of a stock option).

(E) Service Recipient Stock:

Notice 2005-1 provides that the term "service recipient" refers to the person for whom the services are performed, and all persons with whom such person would be considered a single employer under Code section 414(b) (employees of controlled group of corporations), and all persons with whom such person would be considered a single employer under Code section 414(c) (employees of partnerships, proprietorships, etc., which are under common control). Those Code section generally require common ownership of at least 80 percent. The proposed regulations generally lower the threshold to at least 50 percent. Thus, the stock of a parent that owns only 50% of an entity will qualify as service recipient stock. In addition, where the use of stock is based upon a legitimate business criteria, the threshold can be lowered to at least 20 percent. As an example, the proposed regulations indicate that the lower 20 percent threshold can be used with respect to a joint venture if the applicable entity owns at least a 20 percent interest in the joint venture.

(iii) Restricted Property:

Consistent with Notice 2005-1, the proposed regulations provide that there is no deferral of compensation if a service provider receives property merely because the value of the property is not includible in income (under Code section 83) in the year of receipt by reason of the property being nontransferable and subject to a substantial risk of forfeiture, or is includable in income (under Code section 83) solely due to a valid election under Code section 83(b). However, the proposed regulations provide that Code section 409A generally applies to the receipt of a legally binding right to receive property (whether or not restricted property) in a future year. Thus, restricted stock units (RSUs) will generally be subject to the new rules, while restricted stock will not be (assuming the requirements prescribed above are satisfied). However, RSUs may qualify for the short-term deferral exception if the stock is actually paid within the relevant 2-1/2 month period following the vesting of the RSUs.

(iv) Split Dollar Life Insurance

The preamble to the proposed regulations, but not the regulations themselves, address the potential applicability of Code section 409A to split dollar life insurance arrangements. The preamble provides that the requirements of Code section 409A may apply to certain split dollar life insurance arrangements. Specifically, the preamble provides:

(A) split dollar life insurance arrangements that provide only death benefits (as defined in the proposed regulations) to or for the benefit of the service provider may be excluded from coverage under the exception for death benefit plans;

(B) split dollar life insurance arrangements that are treated as loan arrangements under Regulations section 1.7872-15 (i.e., generally collateral assignment method split dollar) generally will not give rise to deferrals of compensation, provided that there is no agreement under which the service recipient will forgive the related indebtedness and no obligation on the part of the service recipient to continue to make premium payments without charging the service provider a market interest rate on the funds advanced.

(C) split dollar life insurance arrangements structured under the endorsement method, where the service recipient is the owner of the policy but where the service provider obtains a legally binding right to compensation includible in income in a taxable year after the year in which a substantial risk of forfeiture (if any) lapses, may provide for the deferral of compensation.

Representatives of the Treasury and IRS have indicated, since the issuance of the proposed regulations, that there is no intent to provide special rules for split dollar arrangements. The preamble was intended only to describe the Treasury and IRS' current views on the application of the general 409A principles to split dollar arrangements. In addition, they have requested that interested parties submit comments on the extent to which, if any, relief is needed so that grandfathered split dollar arrangements (i.e., those entered into on or before September 17, 2003) can be modified to comply with Code section 409A without jeopardizing the grandfather status under the split dollar tax rules.

(v) Separation Pay Arrangements:

Notice 2005-1 includes a special rule for 2005 with respect to certain severance pay arrangements. Under the special rule, a plan that provides severance pay benefits, and that is either (A) a collectively bargained plan or (B) covers no service providers who are key employees (as defined in Code section 416(i) and the regulations thereunder), is not required to meet Code section 409A during calendar year 2005 with respect to such severance pay benefits. Although the proposed regulations do not extend this special rule, the regulations do include a number of new exceptions for "separation pay arrangements," which are generally defined as arrangements providing payments upon a termination of services.

To begin with, separation pay arrangements providing for short-term payments upon an involuntary separation from service are exempt if the following requirements are met: (I) the entire amount of payments does not exceed two times the service provider's annual compensation (for the calendar year before the year in which the service provider separates from service), or, if less, two times the limit on annual compensation that may be taken into account for qualified plan purposes under Code section 401(a)(17) (\$210,000 for calendar year 2005), and (II) the arrangement requires that all payments be made by no later than the end of the second calendar year following the year in which the service provider terminates service.

The proposed regulations also provide that certain window programs (which provide a service provider with an incentive to voluntarily separate from service and obtain a benefit) will generally be treated as involuntary separations from service for purposes of the exceptions from coverage from Code section 409A. In addition, the proposed regulations clarify that involuntary separation pay arrangements can be structured to meet the requirements for the short-term deferral

exception. For this purpose, the right to a payment that will only be paid upon an involuntary termination of services generally will be viewed as a nonvested right.

The proposed regulations also provide that certain reimbursement arrangements related to a termination of services are excepted if the arrangements cover only expenses incurred and reimbursed before the end of the second calendar year following the calendar year in which the termination occurs and generally include reimbursements that are otherwise excludible from gross income, reimbursements for expenses that the service provider can deduct under Code section 162 or 167, outplacement expenses, moving expenses, medical expenses, as well as other types of payments that do not exceed \$5,000 in the aggregate during any given taxable year.

The proposed regulations essentially adopt the plan aggregation rules set forth in Notice 2005-1, which generally provide that Code section 409A is applied as if (A) a separate plan or plans is maintained for each service provider, and (B) all compensation deferred with respect to a particular service provider under an account balance plan is treated as deferred under a single plan, all compensation deferred under a nonaccount balance plan is treated as deferred under a single plan, and all compensation deferred under a plan that is neither an account balance plan nor a nonaccount balance plan (e.g., discounted stock options) is treated as deferred under a single plan. However, the proposed regulations expand the categories of plans that must be aggregated to include a fourth - namely, separation pay arrangements. Under these general aggregation rules, a violation by one participant generally does not cause the entire plan to fail to comply with Code section 409A. However, representatives of the Treasury and IRS have indicated informally that there may be circumstances where a violation that does not directly affect all participants taints the entire plan and causes adverse tax consequences for all participants (e.g., where the operations of the plan indicate that amounts are currently available to all participants notwithstanding the terms of the plan).

(vi) Wrap Plans:

The proposed regulations include special rules that will allow certain wrap plans (i.e., nonqualified plans linked to qualified plans) to continue to operate if certain requirements are satisfied, which may require changes to existing arrangements. For example, the regulations provide that wrap 401(k) plans can be maintained if, among other requirements, the actions or inactions of a participant under the 401(k) plan do not result in an increase in the amounts deferred under the nonqualified plan in any calendar year in excess of the deferral limits under Code section 402(g) (i.e., \$14,000 in 2005).

(vii) Foreign Arrangements:

The proposed regulations provide guidance with respect to the application of Code section 409A to various foreign arrangements. Under the general rule, a foreign arrangement is not subject to section 409A to the extent the compensation subject to the arrangement would not have been includible in gross income for Federal tax purposes if it had been paid to the service provider at the time that the legally binding right to the compensation first arose or, if later, the first time that the legally binding right was no longer subject to a substantial risk of forfeiture, and the service provider was a nonresident alien at such time. The proposed regulations also provide for similar exceptions with respect to amounts excluded from gross income at the applicable time prescribed in the preceding sentence under a tax treaty, or Code section 911 (foreign earned income), 893 (certain compensation paid to foreign workers of a foreign government or international organization working in the United States), 872 (certain compensation earned by nonresident aliens), 931 (certain

compensation earned by bona fide residents of Guam, American Samoa, or the Northern Mariana islands) or 933 (certain compensation earned by bona fide residents of Puerto Rico). In addition, the proposed regulations include limited exceptions for certain broad-based foreign plans and a de minimis rule for certain amounts earned by nonresident aliens (i.e., generally \$10,000 or less per calendar year).

(viii) Partners and Partnerships:

Notice 2005-1 provides interim guidance regarding the application of Code section 409A to arrangements between partnerships and partners. The Treasury and the IRS indicated in the preamble to the proposed regulations that they are still analyzing this area, and other than a clarification in the preamble (discussed below), the proposed regulations do not provide any additional guidance. Accordingly, taxpayers can continue to rely on the interim guidance in Notice 2005-1 until further guidance is issued. In the preamble, the Treasury and IRS indicated that until further guidance is issued, Code section 409A will only apply to guaranteed payments described in Code section 707(c) (and rights to receive such guaranteed payments in the future) if (A) the guaranteed payment is for services, and (B) the partner providing services does not include the payment in income by the 15th day of the third month following the end of the taxable year of the partner in which the partner obtained a legally binding right to the guaranteed payment or, if later, the taxable year in which the right to the guaranteed payment is first no longer subject to a substantial risk of forfeiture.

(4) Initial Deferral Election Rules

(a) General Rules:

Under the general rule, a service provider must make a deferral election in the taxable year before the year in which the services are performed. The proposed regulations clarify that an election to defer an amount includes an election both as to the time and form of the payment. In addition, an election is treated as made as of the date the election becomes irrevocable. The proposed regulations also clarify that evergreen deferral elections can satisfy the deferral election rules if the elections become irrevocable with respect to future compensation no later than the last permissible date an affirmative initial deferral election could have been made with respect to such compensation.

(b) Nonelective Arrangements:

The proposed regulations clarify that the initial deferral election rules do not apply to nonelective arrangements, which are defined as arrangements that do not provide the participant with any election with respect to the amount deferred or the time and form of payment. In addition, an arrangement will qualify as a nonelective arrangement only if it specifies the time and form of payment no later than the time the service provider obtains a legally binding right to the compensation. If a participant is provided with an election with respect to the time and form of payment, the election must be made in accordance with the initial deferral election rules.

(c) Performance-Based Compensation:

There is an exception to the initial deferral election rules for performance-based compensation, which provides that the initial deferral election with respect to such compensation can be made at least 6 months before the end of the performance period, provided such performance

period is at least 12 months. Notice 2005-1 does not provide a definition of performance-based compensation. However, Notice 2005-1 provides a definition of bonus compensation that, until further guidance is issued, can be used for purposes of applying the exception to the general rule regarding initial deferral elections. The proposed regulations include a definition of performance-based compensation and provide guidance for purposes of applying the exception.

Under the proposed regulations, performance-based compensation is defined as compensation the payment of which or the amount of which is contingent on the satisfaction of preestablished organizational or individual performance criteria. The regulations provide that performance-based compensation generally can be based on subjective performance criteria, provided that the determination of whether the subjective performance criteria have been met is not made by the service provider or a member of the service provider's family, or a person the service provider supervises or over whose compensation the service provider has any control. The performance criteria must be established within 90 days of the commencement of the period of service to which the criteria relates, provided that the outcome is not substantially certain at the time the criteria are established. The proposed regulations clarify that the applicable standard is met if, at the time of the initial deferral election, either the amount is not readily ascertainable, or the right to the amount is not substantially certain.

The proposed regulations provide, in contrast to the exception for bonus compensation provided in Notice 2005-1, that performance-based compensation can be based solely upon an increase in the value of the service recipient, or the stock of the service recipient, after the date of grant or award. However, the proposed regulations also clarify that this exception does not apply with respect to an election to defer amounts payable under a stock right (e.g., arrangements that provide for the deferral of stock option gains). The regulations expressly provide that a stock right with a deferral feature is subject to Code section 409A from the date of grant, and therefore, in order to comply, such an arrangement would be required to specify a permissible payment time and a form at the date of grant.

(d) First Year of Eligibility:

There is an exception to the initial deferral election rules in the case of a new plan or a participant first becoming eligible under a plan, which provides that the initial deferral election must generally be made within 30 days of initial eligibility and can only apply to compensation for services performed after the election. The proposed regulations clarify that the plan aggregation rules apply for purposes of this exception. As a result, if a participant was previously eligible to participate in another plan of the same type (e.g., account plan, nonaccount plan, separation pay plan or other plan), the participant will not be eligible for this exception with respect to the new plan.

(e) Special Rule With Respect to Certain Forfeitable Rights:

The proposed regulations include a new exception for certain forfeitable rights that are granted during the middle of a taxable year. The general initial election deferral rules would require a deferral election to have been made prior to the beginning of such taxable year. To address this situation, the proposed regulations provide that where a grant of nonqualified deferred compensation is subject to a forfeiture condition requiring the continued performance of services for a period of at least 12 months, the initial deferral election may be made no later than 30 days after the date of grant, provided that the election is made at least 12 months in advance of the end of the service period. Thus, if an item of compensation is subject to at least a 13-month vesting period, a

deferral election can be made during the calendar year in which it is first granted, provided the requirements for this special rule are satisfied.

(f) Special Rule With Respect to Fiscal Year Compensation:

The proposed regulations include guidance with respect to service recipients (e.g., employers) with fiscal years and who base compensation on service periods that are coextensive with one or more of the service recipient's consecutive fiscal years and where no amount of such compensation is payable during the service period. In that case, the regulations provide that the initial deferral election rules are generally satisfied if the initial election to defer the fiscal year compensation is made on or before the end of the fiscal year immediately preceding the first fiscal year in which any services are performed for which the compensation is paid. Where the compensation is not specifically based upon the service recipient's fiscal year as the measurement period, the regular initial deferral election rules apply.

(g) Special Rule With Respect to Commissions:

The proposed regulations include a special rule for determining when the services are performed with respect to certain "commission compensation" for purposes of applying the initial deferral election rules. The proposed regulations define commission compensation as compensation earned by a service provider if a substantial portion of the services provided by such service provider to a service recipient consist of the direct sale of a product or service to a customer, the compensation paid by the service recipient to the service provider consists of either a portion of the purchase price for the product or service or an amount calculated solely by reference to the volume of sales, and payment of the compensation is contingent upon the service recipient receiving payment from an unrelated customer for the product or services. Under the special rule, for purposes of applying the initial deferral election rules, the service provider is treated as providing the services to which the compensation relates only in the year in which the customer remits payment to the service recipient. Thus, renewal commissions may be eligible for this special rule and an insurance agent may be able to make a deferral election in the calendar year prior to the calendar year in which the insured pays the premiums to the insurance company with respect to which the renewal premiums are paid. However, if the insured does not make any premium payments (e.g., the underlying policy is completely paid up), it is unclear whether this special rule would apply (Treasury and IRS representatives have requested comments on this issue).

(5) Time and Form of Payment

(a) General:

In general, Code section 409A requires that payments of the deferred compensation be made at a fixed date or under a fixed schedule, or upon any of five events: (i) a separation from service, (ii) death, (iii) disability, (iv) change in the ownership or effective control of a corporation, or (v) unforeseeable emergency.

(b) When Actual Payments Must Generally Be Made:

The proposed regulations provide relatively flexible rules regarding when payments must actually be made in order to comply with the payment rules. To begin with, the regulations provide that where the time of payment is based upon the occurrence of a specified event (as opposed to a fixed date or under a fixed schedule), the plan must designate an objectively determinable date or

year following the event upon which the payment is to be made (e.g., 30 days following separation from service, or the first calendar year following the service provider's death). In addition, the regulations provide that a payment will be treated as made upon the designated date if the payment is made by the later of: (i) the first date it is administratively feasible to make such payment on or after the designated date, or (ii) the end of the calendar year containing the designated date (or the end of the calendar year if only a year is designated). However, for purposes of applying this rule, the regulations provide further that any inability to make the payment that is caused by an action or inaction of the service provider, or any related or controlled person, will not cause the payment to be treated as administratively infeasible to make.

(c) Specified Time or Fixed Schedule of Payments:

The proposed regulations clarify that a plan will be deemed to provide for a specified time or fixed schedule of payments where the specific date upon which payment or payments will be made may be objectively determined. The regulations also provide that plans can simply specify the calendar year or years in which the payments are scheduled to be made, without specifying the particular date within such year on which the payment will be made. In addition, the regulations clarify that payments can be determined based upon the date a service provider vests in the amount of deferred compensation, where the vesting is based upon the occurrence of an event (e.g., a participant designates that payment will be made in three installments, payable each December 31 following an initial public offering).

(d) Separation from Service:

(i) Employees:

The proposed regulations provide that an employee experiences a separation from service if the employee dies, retires, or otherwise has a termination of employment with the employer. For this purpose, the regulations provide further that whether a termination of employment has occurred is determined based on the facts and circumstances. In addition, the regulations provide that there is no separation from service while an employee is on military leave, sick leave, or other bona fide leave of absence if the period of such leave does not exceed six months, or if longer, so long as the individual's right to reemployment with the service recipient is provided either by statute or contract. The proposed regulations also include anti-abuse provisions to prevent a circumvention of the rules (e.g., an agreement to continue to perform services where there is no intent to perform any significant services in an attempt to delay distributions following a separation from service; or an arrangement to continue to perform significant services following a purported separation from service in order to trigger a distribution of the deferred compensation). The Regulations also clarify that the same desk rule does not apply for purposes of determining whether there has been a separation from service.

(ii) Independent Contractors:

The proposed regulations provide that an independent contractor is considered to have a separation from service with the service recipient upon the expiration of the contract (or in the case of more than one contract, all contracts) if the expiration constitutes a good-faith and complete termination of the contractual relationship. The regulations provide further that this standard is not met if the service recipient anticipates a renewal of a contractual relationship or the independent contractor becoming an employee. In addition, the regulations include a safe harbor, under which a payment is deemed to be on account of a separation from service. The safe harbor is met if the plan

provides that: (A) no amount will be paid for at least 12 months after the contract (or contracts) expires, and (B) no amount will be paid if, after the expiration of the contract (or contracts) and before the expiration of the 12-month period in (A), the participant performs services for the service recipient as an independent contractor or an employee.

(e) Delayed Distributions for Key Employees:

Code section 409A includes a special distribution rule for key employees (within the meaning of Code section 416(i), but determined without regard to subsection (i)(5)) of publicly-traded companies, which provides that a distribution on account of a separation from service must be delayed for at least 6 months following the separation from service. The proposed regulations include guidance regarding the application of this special distribution rule.

To begin with, the regulations provide that the identification of key employees is based upon the 12-month period ending on the identification date chosen by the service recipient. Individuals who meet the requirements during that 12-month identification period are considered key employees for the 12-month period commencing on the first day of the 4th month following the end of the 12-month identification period. The preamble explains that this delay in the key employee determination is intended to give service recipients time to gather the information and make a determination before payments are actually required to be made.

The regulations also provide that a service recipient may satisfy the 6-month delay requirement by (i) delaying any payments due within the 6-month period until the end of the 6 month period, (ii) delaying each scheduled payment that becomes payable pursuant to a separation from service for six months, or (iii) a combination of the methods described in (i) and (ii). In addition, the regulations provide that a plan may provide a participant an election as to the manner in which the 6-month delay will be implemented, provided that the election complies with the otherwise applicable deferral election rules.

The preamble to the regulations also explained that the Treasury and IRS declined to provide an exception to the 6-month delay requirement for certain types of payments requested by several commentators (e.g., life annuities and longer-term installment payments) because the Treasury and IRS believe that the statutory language does not contemplate such an exception.

(f) Death or Disability:

The proposed regulations incorporate the definition of disability provided in Code section 409A(a)(2)(C) and clarify that: (i) a plan need not provide for a payment upon all disabilities identified under Code section 409A, and (ii) a service recipient may rely upon a determination of the Social Security Administration with respect to the existence of a disability.

(g) Change in Ownership or Effective Control of a Corporation:

Notice 2005-1 prescribes detailed rules regarding what constitutes a change in the ownership of a corporation, a change in the effective control of a corporation and a change in the ownership of a substantial portion of the assets of a corporation (collectively referred to in the notice as "Change in Control Events"). (See Notice 2005-1, Q&As-11 through 14). The proposed regulations incorporate essentially the same guidance (see Proposed Regulations section 1.409A-3(g)(5)). However, the proposed regulations do include several new items. First, the preamble to the proposed regulations indicate that the Treasury and IRS intend to issue regulations that will allow a

distribution upon a Change in Control Event involving a partnership, and, until further guidance is issued, the existing guidance with respect to corporations can be followed by analogy with respect to partnerships. Second, the proposed regulations provide guidance regarding certain earn-out provisions, which are described to include an arrangement where an acquirer contracts to make an immediate payment at the closing of a transaction with additional amounts payable at a later date, subject to the satisfaction of specified conditions. The regulations provide further that the later payments could create delays in payments of compensation calculated by reference to the value of the target corporation shares. In this situation, the regulations provide a special rule under which the compensation payable can be treated as paid at a specified time or pursuant to a fixed schedule if (i) the compensation is paid on the same schedule and under the same terms and conditions as payments to shareholders generally pursuant to a Change in Control Event, and (ii) the compensation is paid not later than five years after the Change in Control Event.

(h) Unforeseeable Emergency:

The proposed regulations generally incorporate the provisions from Code section 409A(a)(2)(B)(ii), which defines an unforeseeable emergency.

(i) Multiple Payment Events:

The proposed regulations provide that payments may be made upon the earlier of, or the later of, two or more specified permissible payment events or times (e.g., the earlier of age 65 or separation from service). In addition, the regulations provide that different forms may be elected for each potential payment event (e.g., installments upon separation from service or, if earlier, a lump sum payment upon death).

(j) Delay in Payment by Service Recipient:

The proposed regulations provide that a plan may provide that payments may be delayed beyond their otherwise required payment date in the following circumstances without violating Code section 409A: (i) the service recipient reasonably anticipates that the service recipient's deduction with respect to such payment would be limited or eliminated by application of Code section 162(m) (i.e., the \$1 million cap on compensation), (ii) the service recipient reasonably anticipates that the making of the payment will violate a term of a loan agreement, or other similar contract, and the violation will cause material harm to the service recipient, and (iii) the service recipient reasonably anticipates that the making of the payment will violate Federal securities laws or other applicable law. The regulations provide further that a plan generally can be amended to include one or more of such provisions, provided the amendment is not effective for at least 12 months; however, once a plan includes such provisions, it cannot be amended to remove them (i.e., it will be treated as a prohibited acceleration of the payment).

(k) Disputed Payments and Refusals to Pay:

The proposed regulations provide that a payment can be delayed in certain cases if the payment is not made on the date scheduled because the obligation to make the payment or the amount of the payment is in dispute, or the service recipient simply refuses to pay. To fall within this special rule, the service provider must act in good faith and must make reasonable, good faith efforts to collect the amount. In addition, the payment must be made by the end of the calendar year (or, if later, the 15th day of the third month following the date) in which: (i) the service recipient and the service provider enter into a legally binding settlement of such dispute, (ii) the service

recipient concedes that the full amount is payable, or the service recipient is required to make such payment pursuant to a final and nonappealable judgment or other binding decision.

(6) Anti-Acceleration of Payments

(a) General:

Except as expressly permitted by the Treasury and IRS, a plan may not permit the acceleration of the time or schedule of any payment. Notice 2005-1 provides a number of exceptions, including payments necessary to comply with a domestic relations order, payments necessary to comply with certain conflict of interest rules, payments intended to pay employment taxes, and certain de minimis payments related to the termination of the participant's interest in the plan. The proposed regulations incorporate all of the permissible accelerations provided in Notice 2005-1, and provide a number of additional permissible accelerations.

(b) Payments Upon Income Inclusion Under Code Section 409A:

The proposed regulations provide that a plan may permit the acceleration of a payment to pay the amount the service provider includes in income as a result of the plan failing to meet the requirements of Code section 409A.

(c) Payments Following Plan Termination:

Under the general rule, payments cannot be accelerated upon termination of a plan. However, the regulations permit such accelerations in three circumstances:

(i) a plan may be terminated provided that all arrangements of the same type (account balance plans, nonaccount balance plans, separation pay plans or other arrangements) are terminated with respect to all participants, no payments other than those otherwise payable under the terms of the plan absent a termination of the plan are made within 12 months of the termination of the arrangement, all payments are made within 24 months of the termination of the arrangement, and the service recipient does not adopt a new arrangement of the same type at any time for a period of five years following the date of termination of the arrangement;

(ii) a plan may be terminated during the 12 months following a Change in Control Event; and

(iii) a plan may be terminated upon a corporate dissolution under Code section 331, or with the approval of a bankruptcy court pursuant to 11 U.S.C. section 503(b)(1)(A), provided that the amounts deferred under the plan are included in the participants' gross incomes by the latest of (A) the calendar year in which the plan termination occurs, (B) the calendar year in which the amount is no longer subject to a substantial risk of forfeiture, or (C) the first calendar year in which the payment is administratively practicable.

(d) Terminations of Deferral Elections Following an Unforeseeable Emergency or a Hardship Distribution:

The proposed regulations provide that a plan may provide that a deferral election terminates if a service provider obtains a payment on account of an unforeseeable emergency, or if such termination is necessary for a service provider to obtain a hardship distribution under a qualified

401(k) plan; provided that the deferral election is terminated and not merely suspended. A deferral election made after a termination of a deferral election under these special rules must be treated as an initial deferral election and must comply with the applicable rules.

(e) Distributions to Avoid a Nonallocation Year Under Code Section 409(p):

Under certain conditions, in the case of an S corporation sponsoring an employee stock ownership plan (ESOP), it may be necessary for amounts to be distributed from a nonqualified deferred compensation plan in order to avoid a nonallocation year within the meaning of Code section 409(p)(3) (which, if not corrected, could result in significant, adverse tax consequences to certain participants in the ESOP). The proposed regulations provide rules under which such distributions can be made to avoid a nonallocation year.

(7) Subsequent Changes in the Time and Form of Payment

(a) General:

Under Code section 409A, the time and form of distribution generally must be designated at the time of the initial deferral election. However, the statute allows for changes that further delay or change the form of payment if all of the following requirements are satisfied: (i) the change does not take effect until at least 12 months after *the date on which the change is made*, (ii) in the case of payments made on account of separation from service, a specified time (or pursuant to a fixed schedule), or following a change in control, the first payment with respect to which the change is made must be deferred for at least 5 years from *the date the payment would otherwise have been made*, and (iii) in the case of any change related to a payment made on account of a specified time (or pursuant to a fixed schedule), the change cannot be made less than 12 months before *the date of the first scheduled payment*. These permitted change rules are collectively referred to hereinafter as the "subsequent deferral rules."

(b) Definition of Payment:

The proposed regulations provide significant flexibility with respect to the definition of payment for purposes of the subsequent deferral rules. To begin with, the proposed regulations provide generally that each separately identified amount to which a service provider is entitled to under a plan on a determinable date is a separate payment for purposes of the subsequent deferral rules. For example, if an arrangement provides that 50% of the benefit will be paid as a lump sum at separation from service, and the remainder of the benefit will be paid as a lump sum at age 60, the arrangement provides for two separately identified amounts.

In addition, the proposed regulations provide that, in general, the periodic payments under either an installment or annuity form of payment are treated as a single payment for purposes of the subsequent deferral rules (e.g., if an arrangement provides for 10 annual installments commencing at age 65, the arrangement provides for a single identified amount paid at age 65 (as opposed to each annual installment being treated as a separate payment). However, the proposed regulations also allow plans to designate installment payments, but not annuity payments, as a series of separately identified amounts (e.g., in the preceding example, each of the 10 annual installments could be treated as a separate payment for purposes of the subsequent deferral rules).

(c) Application to Multiple Payment Events:

As discussed above, plans may allow for payments to be made on the earlier of, or the later of, multiple specified permissible payment events, and also allow for different forms of payment depending on the payment event. For example, an arrangement provides for an annuity at age 65 or, if earlier, a lump sum payment upon separation from service. For purposes of applying the subsequent deferral rules, the proposed regulations provide that the rules are applied to each payment event separately. For example, under the preceding example, the subsequent deferral rules would apply separately to the entitlement to the installment payment at age 65, and the entitlement to the lump sum payment at separation from service.

The proposed regulations also provide that a plan may provide that an intervening event that is a permissible payment event under Code section 409A may override an existing payment schedule already in payment status. For example, a plan could provide for 6 installment payments commencing at separation from service, but also provide that if the participant died after the payments commenced, all remaining benefits would be paid in a lump sum.

(8) Material Modifications to Grandfathered Plans

A grandfathered plan (i.e., a plan that includes only amounts deferred before January 1, 2005) is not subject to Code section 409A unless it is materially modified on or after October 3, 2004. Notice 2005-1 provides guidance about what modifications constitute material modifications for purposes of grandfathered plans. In general, Notice 2005-1 provides that there is a material modification if a benefit or right existing as of October 4, 2004 is enhanced or a new benefit or right is added. The proposed regulations generally incorporate the guidance provided in Notice 2005-1 with respect to material modifications and include a number of new rules and other clarifications. For example, the proposed regulations include a "correction" provision for certain inadvertent material modifications if certain requirements are satisfied. Under this provision, if a modification is rescinded before the earlier of the date any additional right granted under the modification is exercised or the end of the calendar year in which the modification was made, the modification will not be treated as a material modification of the plan. In addition, the proposed regulations clarify that the establishment of a Rabbi trust in connection with a grandfathered plan will not constitute a material modification if the requirements for Rabbi trusts are satisfied.

(9) Information Reporting and Wage Withholding Requirements

The new rules include new reporting and withholding requirements. Notice 2005-1 provides interim guidance on the mechanics of reporting nonqualified deferred compensation on either a Form W-2 or Form 1099-MISC (see Notice 2005-1, Q&As-24 through 38). The proposed regulations do not provide any new guidance on these new requirements, and therefore, taxpayers may continue to rely on Notice 2005-1 until further guidance is issued. In the preamble to the proposed regulations, the Treasury and IRS explained that they understand that a method of calculation of current deferrals and of amounts to be included income is needed for taxpayers to meet their reporting and withholding obligations and specifically requested comments on what transitional relief may be appropriate depending upon when the future guidance is released.

(10) Transition Rules

(a) General:

Notice 2005-1 includes a number of transition rules, most of which were scheduled to expire at the end of 2005. However, the proposed regulations extend most of the transition rules until the

end of 2006, with several notable exceptions. In addition, the regulations also impose new conditions on several of the transition rules that are extended to the end of 2006. These transition rules are discussed separately below.

(b) Amendment and Operation of a Plan:

The proposed regulations extend until December 31, 2006 the deadline by which plan documents must be amended to conform with Code section 409A. Until such time, the regulations provide that a plan must be operated in good faith compliance with Code section 409A and Notice 2005-1.

(c) Changes in Time and Form of Payment:

Notice 2005-1 provides that a plan can be amended to provide for new payment elections with respect to amounts subject to Code section 409A. The new payment elections were originally required to be made by the end of 2005. The proposed regulations extend this transition rule until the end of 2006; however, the extension is subject to a new requirement - any new elections in 2006 cannot affect amounts that would otherwise be received by the taxpayer in 2006.

(d) Payments Based on Elections Under Qualified Plans:

Payment elections under a nonqualified deferred compensation plan that mirror or depend upon a payment election under a qualified plan generally do not satisfy the payment election rules under Code section 409A because such elections generally are not made at the time the deferral election is made. Notice 2005-1 includes a transition rule that allows such payment elections to continue in effect through the end of 2005. The proposed regulations extend this transition rule to the end of 2006, provided that the payment election is made in accordance with the terms of a nonqualified plan as in effect on October 3, 2004.

(e) Substitution of Non-Discounted Stock Rights for Discounted Stock Rights:

Notice 2005-1 allows discounted stock rights that do not comply with Code section 409A to be replaced with non-discounted stock rights that are excepted from the new rules; provided certain requirements are satisfied. These replacements were originally required to be made on or before the end of 2005. The proposed regulations extend this transition relief until the end of 2006.

(f) Initial Deferral Elections:

Under a special rule provided in Notice 2005-1, the initial deferral election with respect to compensation to be earned on or before the end of 2005 could be made as late as March 15, 2005. This transition relief was **not** extended under the proposed regulations. As a result, deferral elections with respect to 2006 compensation will generally need to be made by the end of 2005.

(g) Cancellation of Deferrals and Termination of Participation:

Notice 2005-1 allowed plans adopted before the end of 2005 to provide a participant with the right to terminate participation in the plan or cancel an outstanding deferral election with respect to amounts subject to Code section 409A. This transition relief was **not** extended under the proposed regulations. Accordingly, any such termination or cancellation must be accomplished before the end of 2005.

(h) Termination of Grandfathered Plans:

Notice 2005-1 also provided that a termination of a grandfathered arrangement before the end of 2005 would not be treated as a material modification, provided that all amounts deferred under the arrangements are included in compensation in the year of termination. This transition relief was **not** extended under the proposed regulations. As a result, any such termination must be accomplished before the end of 2005.

(11) Matters Not Covered by Guidance To Date(a) Funding Arrangements:

Code section 409A also includes new rules regarding the funding of deferred compensation arrangements. These new rules generally provide that assets that are located outside of the United States (e.g., offshore Rabbi trusts) or that become restricted to the payment of deferred compensation in connection with a change in the employer's financial health are taxable to participants when transferred outside of the United State or set aside. Although these rules are currently applicable, the Treasury and IRS have not issued any guidance to date. In the preamble to the proposed regulations, they indicated that they intend to address these provisions in future guidance and requested comments on specific issues.

(b) Calculation and Timing of Income Inclusion Amounts:

In the preamble to the proposed regulations, the Treasury and IRS indicate that, in order to issue the proposed regulations earlier, they did not include guidance with respect to the calculation of the amounts of deferrals, the amounts of income inclusion upon the violation of the provisions of Code section 409A, and the timing of the inclusion of income and related withholding obligations. They indicated further that they anticipate that these topics will be addressed in subsequent guidance and requested comments on specific issues.

(12) What Plan Sponsors Should be Doing

Although the proposed regulations extend the date upon which plans must be amended to comply with Code section 409A and extend many of the transition rules until the end of 2006, plans must be operated in good faith compliance with the new rules currently. In addition, a number of the transition rules were not extend beyond 2005, and some that were, include new conditions that may restrict their availability in 2006. As a result, plan sponsors may want to review all of their arrangements now to determine whether they are in operational compliance and to determine whether they should take advantage of any of the transition rules before the end of 2005.

Any AALU member who wishes to obtain a copy of the proposed 409A regulations may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at [www.aalu.org](http://www.aalu.org), enter the *Member Portal* and select *Current Washington Report* for linkage to source material or (3) email Jeff Lavine at [lavine@aalu.org](mailto:lavine@aalu.org) and include a reference to this *Washington Report*.

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