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Earlier this year, the Internal Revenue Service and Treasury Department issued final regulations under Section 409A of the Internal Revenue Code, the most far reaching change in the nonqualified deferred compensation rules since 1978. Because the regulations broadly define the term "deferred compensation," the new rules have the potential to ensnare many arrangements that are not commonly thought of as deferred compensation. Unfortunately, recent comments by IRS officials suggest that an extension of the December 31, 2007 compliance deadline is unlikely.... [more](#) 

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THE RACE TO COMPLY BY DECEMBER 31, 2007: WHAT BUSINESS OWNERS AND EXECUTIVES NEED TO KNOW ABOUT THE NEW NONQUALIFIED DEFERRED COMPENSATION RULES

Surprises are nice, even welcome, when the occasion is a birthday or an anniversary. But surprises are seldom welcome news when they involve a new tax provision. That said, many business owners and executives may be surprised to learn that many commonplace compensation arrangements now have the potential to cause significant adverse tax consequences to covered employees. While the addition of Section 409A to the Internal Revenue Code by the American Jobs Creation Act of 2004 was designed to address abuses from the Enron and similar corporate collapses, IRS and Treasury Department final regulations (totaling 397 pages) issued in mid-April broadly interpret the term "deferred compensation" used in Section 409A. The practical effect of the regulations is that virtually every arrangement providing for the payment of compensation after the year it was earned should be

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reviewed to determine the impact of these new rules, if any. The regulations require that all covered arrangements be brought into written and operational compliance by December 31, 2007. In this issue of *Planning Notes*, we will provide a general overview¹ of Section 409A and the final regulations and provide suggestions for employer actions to comply with this fast approaching deadline².

Overview

Section 409A is the most far-reaching change in the nonqualified deferred compensation rules since 1978. It overlays, rather than replaces, the existing rules and imposes new restrictions on the timing of deferral elections, new limits on when deferred amounts can be distributed, and a new written plan document requirement. Prior to January 1, 2008, when the final regulations become effective, plan sponsors must comply "in good faith" with the statute and existing IRS guidance.

Under the new rules, elections to defer compensation must generally be made prior to the beginning of employee's taxable year in which the compensation is earned. The election must reflect when and the form in which the compensation will be paid. With limited exceptions, acceleration of the payment of amounts deferred is prohibited and subsequent elections to further defer the distribution or change the form of payment must be made at least twelve months in advance of the date the amount would otherwise be paid and the amount must be deferred for a minimum of five additional years.

Restrictions are also imposed on when a distribution of deferred compensation can be made. Generally speaking, benefits may only be paid by reference to a specified time or fixed schedule specified at the time of deferral, or upon "separation from service," disability, death, change of control, or the occurrence of an unforeseeable emergency. For publicly traded companies, additional restrictions are imposed on payments to certain "specified employees" following their separation from service.

An arrangement will not satisfy Section 409A unless the agreement is in writing and includes the employees covered, the amount of compensation to be paid (or the formula used to determine the amount), the time and form of payment, and, if applicable, the conditions for initial and subsequent deferral elections, and the "key" employee restrictions for publicly traded companies. All affected arrangements must be amended to comply with Section 409A by **December 31, 2007**.

An arrangement will also violate Section 409A if it utilizes an offshore funding mechanism or a funding mechanism that is triggered upon the financial downturn of the sponsor.

Not all deferred compensation arrangements must comply with the new Section 409A rules. Major exclusions from coverage include "qualified-type" plans, "grandfathered" arrangements (i.e., plans in which participants were "vested" as of December 31, 2004 and are not materially modified after October 3, 2004), certain short-term deferral arrangements and separation pay arrangements, and equity arrangements where the exercise price is not less than the fair market value as of the date of grant.

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Consequences of Noncompliance

The consequences of failure to comply with Section 409A are severe and fall most heavily on the employee. From his or her perspective, the consequences include immediate taxation on all amounts deferred (in the current year and all prior years) for all arrangements required to be aggregated to the extent those amounts are not subject to a "substantial risk of forfeiture", a penalty equal to 20% of the taxable income amount, and an interest penalty computed based on the years in which the compensation was deferred. For this purpose, a substantial risk of forfeiture means that (i) entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to the purpose of the compensation (e.g., meeting individual or company-related performance goals) and (ii) the possibility of forfeiture is substantial. A covenant not to compete does not constitute a substantial risk of forfeiture for purposes of Section 409A.

From the employer's perspective, the early inclusion in the employee's income will affect the timing of its deduction for such compensation and will implicate reporting and withholding obligations. More importantly though, a failure to keep the plan in compliance will cause an otherwise desirable "perk" to become a significant detriment and will likely frustrate the employer's objectives in offering the plan.

What is Deferred Compensation for Section 409A

As noted earlier, the Treasury Department and the Internal Revenue Service have broadly interpreted the term "deferred compensation" to which Section 409A applies. Simply stated, an amount will be considered deferred compensation if the employee has a legally binding right during a taxable year to compensation that is or may be payable in a later year. It is not necessary that there be employee salary deferrals; thus, the plan may be funded entirely by the employer. An employer cannot have unilateral discretion whether or not to pay the benefits, however, the mere fact that the deferred compensation is subject to a vesting schedule will not cause it to cease to be considered deferred compensation.

Given this broad definition of deferred compensation, employers will need to identify potentially affected arrangements. Foremost, it is clear that there does not have to be a "plan" per se. To the contrary, examples of deferred compensation may be found in post-termination provisions of employment agreements, bonus payments, director fee deferrals, change of control agreements, severance or separation pay agreements, certain equity compensation arrangements (such as non-qualified stock options, stock appreciation rights or phantom stock arrangements), split-dollar arrangements, certain consulting agreements within independent contractors, and agreements to reimburse certain expenses or provide in-kind benefits³.

Important Exceptions and Exclusions

The broad reach of Section 409A applies to all amounts that are considered deferred compensation unless they are specifically

excepted or excluded. "Qualified" retirement plans (i.e., Section 401(a)), Section 403(b) tax sheltered annuities, Section 457(b) plans, simplified employee pensions and SIMPLE plans are excepted as are qualified incentive stock options, bona fide vacation pay, sick pay, disability pay and death benefit plans.

Grandfathered Arrangements: Another important exception is for "grandfathered" arrangements. Deferred compensation plans in which the participant was earned and vested as of December 31, 2004 (meaning that the employee was not required to provide any further services to be entitled to the benefit), which are not materially modified after October 3, 2004, and which have been administered in accordance with its terms are not subject to Section 409A. Generally, a material modification occurs when the arrangement is amended after that date even if a feature permitted by Section 409A is added.

Short-term Deferrals: Another important exception is the short term deferral exemption. An amount is not considered deferred compensation if it is paid in the year in which the amount vests or within 2½ months after the end of the later of the employee's taxable year or the end of the employer's taxable year in which the amount vests. The arrangement must not have any written provision that would permit payment to be made at a later date, even if the amount is paid within the 2½ month period.

Separation Payments: Another important exception is for separation payments. An arrangement will not be subject to Section 409A to the extent it provides for payments on an involuntary separation from service or pursuant to a window program provided (i) payments do not exceed twice the lesser of the employee's annualized rate of compensation for the preceding taxable year (with certain adjustments) or the qualified plan compensation limit for the year of separation (\$225,000 for 2007) and (ii) all payments are made no later than the end of the second calendar year after the year of separation from service. Generally speaking, the documentation governing the separation will be determinative if the termination was voluntary or not. A "good reason" termination may also constitute an involuntary termination to which the exception applies. The regulations provide a safe harbor test for this determination.

This exception does not apply outside of a window program unless the termination was involuntary. If the benefit could have been paid for another reason, this exception does not apply even if it is paid due to an involuntary separation or participation in a window program.

Stock Options: Another important exception to coverage under Section 409A is for non statutory stock options whose exercise price is not less than the fair market value of the stock at the date of grant. The stock option must involve "service recipient stock", which is essentially any common stock of the employer or any corporation above it in the chain of corporations, provided the stock does not have a preference on dividends. For non-publicly traded stock, a number of valuation safe harbors are set forth and the employer's determination may be rebutted only if "grossly unreasonable". A special valuation rule applies to illiquid start-up companies.

Miscellaneous Exceptions: Finally, also excepted from coverage under Section 409A are indemnification payments, certain reimbursement arrangements, legal settlements, and golden parachute gross-ups.

Deferral Restrictions

Different rules apply to initial deferral elections and subsequent elections to change or defer the commencement or to change the form of payment. Initial elections must be made in the year before the compensation is earned, must include the time and form of payment, and must be irrevocable by the deadline date. There are exceptions to that deadline for new or re-hired participants, and for performance-based compensation.

Subsequent elections to defer the payment from its originally scheduled date or to change the form in payment may not take effect for 12 months, must be made at least 12 months before the date payments are scheduled to be made, and must provide for a new distribution date that is at least five years from the date when the distribution would otherwise have been made. In the case of installment distributions, these rules can apply to each separate installment if the plan otherwise provides for such treatment.

Distribution Restrictions

To comply with Section 409A, benefits may only be paid by reference to a time or fixed schedule specified at the time of deferral, or one or more of the following events specified in the document: "separation from service", disability, death, change of control or occurrence of an unforeseeable emergency.

Separation from Service: Whether or not there has been a separation from service is based upon an objective, facts and circumstances determination of whether the employee continues to provide significant services to the employer or member of its controlled group. The regulations provide two rebuttable presumptions. First, an employee will be presumed to have separated if his or her level of service amounts to less than 20% of the average level of services over the preceding 36 months. On the other hand, an employee will not be presumed as separated if the level of services is 50% or more than the average over the preceding 36 months.

For "specified employees," a six month delay in distributions is imposed for distributions following separation from service. Generally speaking, "specified employees" are certain key employees in publicly traded companies.

Specified Date: A provision that provides for payment upon a specified date or an implicit date (for example, when the participant attains age 65), will qualify as made pursuant to a specified time or fixed schedule. In contrast, an event whose date of occurrence is not known at the outset, such as when the plan sponsor makes an IPO, will not qualify.

Other Events: Distributions may also be made upon the employee's disability or upon a change of control of the employer.

Both of these terms are specifically defined terms in the statute.

The unforeseeable emergency event is more restrictive than a hardship standard applicable to Section 401(k) plan. For these purposes, distributions are generally limited to illness or accident of the employee and family members, loss of property due to casualty, or other extraordinary circumstances.

Payment Rules: An arrangement may provide for distributions to be made on the earliest or latest of several events so long as there is no room for discretion by any party. Different triggering events can have different forms of payment but no single event can have alternate forms of payment. Where the plan provides for distributions by a certain date, the payment will be considered timely if it is made after the scheduled payment date in the same calendar year, or if later, within 2½ months following the scheduled payment date. If the plan provides for payment as soon as reasonably administratively feasible after an event, the payment will be timely only if the plan restricts the payment period to the taxable year or must be no longer than 90 days and the employee must not be permitted to elect the taxable year of payment.

Delays in Payment: There are limited exceptions which will permit the employer to delay payment beyond the scheduled payment date and still be deemed timely for purposes of these rules. Most important of these are bona fide disputes over the benefit amount, avoiding violations of securities or other applicable law, and operation of a fixed or objective formula or limitation, such as a percentage of cash flow.

Acceleration of Payments: There are also limited exceptions to the prohibition upon acceleration of distributions. Most important of these include: an intervening distribution event, such as permitting installment distributions to be paid in a lump sum upon the employee's death; distribution of the amount includable in the employee's income as a result of Section 409A violation; and upon plan termination provided (i) it does not occur approximate to a financial downturn of the employer, (ii) all plans of the same type maintained by the employer are terminated with respect to all participants, (iii) no payments are made within 12 months of plan termination except for those that would have been paid absent the termination, (iv) all payments are made within 24 months of termination, and (v) the employer does not adopt a plan of the same type for a period of three years following the date of termination.

Other Distribution Triggers: Distributions may also be made upon plan termination in connection with certain changes in control, certain corporate liquidations, or with approval of the bankruptcy court with jurisdiction over the employer's plan.

Documentary Requirements

The material terms of the arrangement must be in writing and, at a minimum, must include the employees covered; the amount of compensation (to be paid or the formula used to determine the amount; the time and form of payment; and, if applicable, the conditions for initial and subsequent deferral elections, and the "specified employee" delay for distributions from plans of publicly

traded companies. For plans that provide for employee deferrals, the plan must be in writing no later than the date of the initial election.

Although the regulations take a minimalist approach with regard to plan documents, it may be advisable to include other provisions. After December 31, 2007, generally speaking, the deferral and distribution provisions in the plan cannot be changed without violating the prohibition on accelerations or having to comply with the subsequent deferral rules. This underscores the importance of reviews of potentially affected arrangements before December 31, 2007.

The regulations make clear that "savings clauses" will be of limited utility. Thus, if the plan omits a necessary term or contains provisions that do not comply with Section 409A, a clause designed to add omitted provisions or negate improper provisions generally will not be given effect.

Plan Sponsor Action Items by December 31, 2007

The final regulations impose a **December 31, 2007** deadline by which all plan documents must be brought into compliance. In public comments since then, IRS has indicated repeatedly that this deadline will not be extended. Because of the broad reach of the statute, what this means is that between now and December 31, 2007 employers will need to:

- ♦ identify all potentially affected arrangements;
- ♦ determine the impact of Section 409A, the final regulations and other guidance;
- ♦ re-design and amend plan documents (after any necessary negotiation of changes);
- ♦ communicate the changes to affected employees;
- ♦ obtain necessary compensation committee or Board of Director approval for newly amended arrangements;
- ♦ implement as appropriate, new deferral and payment elections;
- ♦ determine whether securities laws reporting requirements apply to new or amended arrangements;
- ♦ assure procedures are in place to comply with reporting and withholding obligations; and
- ♦ document "good faith" operational compliance since January 1, 2005, the effective date of the statute.

In addition to meeting this deadline, employers will also need to consider whether they should take advantage of amendments permitted during this transition period. Between now and December 31, 2007, distribution provisions in arrangements can be amended to change the distribution options without violating the anti-acceleration rules or having to comply with the subsequent deferral rules, although any such amendment can only apply to amounts not otherwise payable in 2007 and may not cause an amount to be paid in 2007 that would not otherwise be payable in 2007.

Concluding Thoughts

At one time, regulations issued by the Treasury Department and the Internal Revenue Service were "principles based", meaning that regulations set forth very broad principles with which taxpayers were expected to comply. The regulations under Section 409A reflect the more modern trend of the IRS and the Treasury Department to issue "rules based" regulations, which attempt to provide the rule for each and every possible factual scenario without room for significant interpretation. It is debatable whether taxpayers and tax practitioners brought this upon themselves based on positions taken with respect to principles based regulations, but the unfortunate fact is that the reach of the final regulations is so broad and the rules so detailed that they will significantly complicate compliance with Section 409A by the average employer. One can only hope that the IRS will take a reasonable approach and not assert Section 409A violations for technical foot faults.

¹ At the risk of stating the obvious and with the intention of having some semblance of readability, this newsletter is not designed to be a comprehensive review of the final regulations.

² The application of these rules is not limited to common law employer-employee relationships. Nevertheless, for simplicity, we will use the terms "employer" and "employee" to refer to all types of affected service recipients and service providers.

³ For simplicity, we will use the terms "plan" and "arrangement" interchangeably.

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