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New 409A Regulations for Nonqualified Deferred Compensation: The End of the Beginning

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Internal Revenue Code (IRC) Section 409A radically changed the structure of nonqualified deferred compensation plans, including severance plans, employment agreements, change of control agreements, and supplemental benefit plans. Although described by many as a response to certain executive compensation practices at corporations such as Enron, WorldCom, and others, all employers are affected, including small and not-for-profit employers. Now that final regulations were issued in April 2007, all plans must document compliance by the end of 2007, and be ready to comply with the final regulations starting in 2008. This column helps to prepare employers for that task by discussing some of the major features of IRC Section 409A and the final regulations.

IRC Section 409A potentially affects all employers who sponsor nonqualified deferred compensation plans, including severance plans, employment agreements, change of control agreements, and supplemental benefit plans. Since the statute became effective in 2005, taxpayers have tried to follow these numerous new rules in "good faith" compliance, knowing that at some point the more liberal transition relief would end. With the publication of final regulations in April 2007, the Treasury Department and the IRS have announced the "good faith"

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compliance period will end in 2007, and taxpayers must comply with the final regulations starting in 2008.

Very generally, IRC Section 409A(1) requires that any election to defer compensation or postpone receipt further be made in advance and designate a fixed date of payment in accordance with specified terms; (2) limits flexibility to accelerate or change the date chosen to receive deferred compensation; and (3) in some cases, delays receipt of compensation for six months after a "specified individual" (a key employee) terminates employment.

It is important to note that IRC Section 409A encompasses not only agreements between employers and employees, but covers deferred compensation agreements with third parties such as directors, consultants, and other independent contractors. Thus, the statute and regulations use the terms "service providers" and "service recipients" to describe the parties affected by IRC Section 409A, although this column may sometimes refer to affected parties as employers and employees. Similarly, the use of the term "plan" herein also refers to agreements and arrangements that provide for deferred compensation.

Effective Dates

IRC Section 409A became effective in 2005, but grandfather and transition rules apply. The final regulations will apply on January 1, 2008, and all documents must be revised before that date to reflect the new rules. Taxpayers must follow the statute and interim guidance "in good faith compliance" in the meantime.

Interim guidance included IRS Notice 2005-1, six additional pieces of guidance, and proposed regulations.[1] The IRS issued Notice 2006-79 in October 2006, which gave plan sponsors through 2007 to comply with certain technical requirements of IRC Section 409A (the plan amendment and documentation requirements), and also offered some limited operational transition relief. For example, as discussed below, changes in distribution elections, which under Section 409A must generally be made a year in advance of scheduled payment and must extend deferrals for five years, are not required to meet those specific requirements until 2008 (although certain conditions, discussed below, do apply), and certain elections made under nonqualified plans linked to qualified plan elections can continue through 2007.

Generally, vested amounts deferred before January 1, 2005, are not subject to IRC Section 409A. Amounts are considered deferred before January 1, 2005, if an employee had a legally binding right to the amount paid, and the right to the amount was earned and vested as of December 31, 2004. Amounts deferred for preceding taxable years may be subject to Section 409A if a grandfathered deferred compensation arrangement is materially modified after October 3, 2004. A material modification occurs whenever a benefit is enhanced or a new benefit or right is added after October 3, 2004.[2] Thus, allowing additional deferral elections or providing new distribution options, even if consistent with IRC Section 409A, would be a material modification.

Penalties

The penalties for failure to comply with IRC Section 409A are severe. All amounts deferred under nonqualified deferred compensation plans that fail to meet the requirements of IRC Section 409A will generally be includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. In addition, interest (cumulative from the failed arrangement's vesting date), will be charged at the federal penalty rate plus one percent, and a 20 percent additional penalty will be imposed on the amount included in income.[3]

Similar types of plans covering individuals are aggregated for purposes of these penalties. Thus, a mistake with respect to one of an employee's deferred compensation plans will subject any other plans of that employee that are aggregated to the Section 409A penalties. An important exception to this harsh treatment applies to a failure to document an arrangement properly. While the improperly documented arrangement will fail IRCSection 409A, other arrangements covering the employee (even if otherwise required to be aggregated) will not be subject to penalties under IRC Section 409A (assuming they are properly documented).[4]

Aggregation Rules

As noted above, a service provider's plans of the same type will be aggregated for purposes of the Section 409A penalty provisions and for certain other rules (*e.g.,* the termination rules), making the penalty provisions potentially much more harsh. The categories of arrangements into which plans must be placed are:

- Elective account plans;
- Non-elective account plans (including employer match plan);
- Involuntary separation pay plans;
- Ancillary reimbursement and in-kind benefits;
- Stock rights;
- Split-dollar life insurance;
- Foreign plans;

- Non-account balance plans (*e.g.*, defined benefit SERPs); and
- Others.

Note that to allow separation of plans for elective and non-elective deferrals, plans may have to be amended to provide for separate record-keeping. Despite the administrative burden, employers may want to consider this approach as it would allow reduced liability if one but not both plans covering an employee has a Section 409A failure.

Arrangements Subject to and Exempt from IRC Section 409A

IRC Section 409A applies to "nonqualified deferred compensation plans," defined as "any plan that provides for the deferral of compensation." A plan provides for the deferral of compensation if, under the terms of the plan and the relevant facts and circumstances, the employee 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 employee in a later year.[5]

The regulations exempt from Section 409A arrangements with service providers who meet all of the following requirements:

1. They are engaged in the business of providing services;
2. They are not providing services as employees or directors;
3. They work for two or more unrelated service recipients; and
4. They are not related to the service recipient.[6]

The final regulations clarify that if at the time the legally binding right arose, the arrangement was not subject to IRC Section 409A, the amount deferred under the arrangement (and earnings) will not become subject to IRC Section 409A in a later year if the relationships between the parties change and deferrals in later years would be subject to IRC Section 409A. Agreements among partners in partnerships and between employees and personal service corporations are subject to the rules, although specific guidance on partnership arrangements has not been issued. However, Notice 2005-1 provides a limited exception, at least temporarily, for the issuance of a certain partnership interests between a partner and a partnership.[7]

Statutory Exemptions

The statute contains the following limited exceptions:

- Qualified employer plans, including 401(a) plans, 403(b) plans, simplified employee pensions under IRC Section 408(k), simple retirement accounts under IRC Section 408(p), qualified governmental excess benefit arrangements under IRC Section 415(m), and Section 457(b) plans;
- Certain nonqualified deferred compensation plans under IRC Section457(e)(12);
- Bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans; and
- Medical reimbursement arrangements, health savings accounts and health reimbursement accounts, and business payments between accrual basis taxpayers.[8]

The final regulations also make it clear that tax-free benefits are not subject to Section 409A.

Short-Term Deferrals

The regulations provide an exception for "short-term deferrals" if, absent an election to defer payment to a later time period, at all times an arrangement requires payment of compensation, and the amount is actually or constructively received, by the later of the 15th day of the third month following the service provider or service recipient's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture.[9] Compensation is not subject to a substantial risk of forfeiture as of the date that an employee first has a legally binding right to such compensation. An arrangement need not provide in writing that payments will be made by the required deadline, but the short-term deferral rules will only apply if amounts are actually paid out by such deadline, and if the plan does not permit other, potentially later payments, such as payment upon separation from service. The rules contain exceptions for unforeseeable administrative or employer solvency issues that could delay payment, but these exceptions are limited.

If, under the rules for payment under IRC Section 409A discussed below, the plan specifically states that payment will be made before the required short-term deferral deadline, and the payment is delayed but made in the same plan year, that payment will likely comply with IRC Section 409A, even if it is not a short-term deferral. So depending on the complexity of the arrangement, employers might want to include a specified short-term deferral date in the document, but they should note that if payment is not actually made by the required short-term deferral date, the arrangement will have to comply with IRC Section 409A in all respects.

Application of the short-term deferral rules often depends on determining when a "substantial risk of forfeiture" ceases. The guidance in the regulations states that if a risk of forfeiture is continually extended in a manner in which the employer can be reasonably assured that a forfeiture condition will not occur, the "risk" will be considered illusory and will be ignored by the IRS for purposes of IRC Section 409A. Payments conditioned on involuntary separation may constitute a substantial risk of forfeiture, so that if such payments are made immediately upon separation, they can be short-term deferrals. Moreover, a significant change in the final regulations provides that separation for "good reason," discussed below, can be considered involuntary separation for this purpose.

Stock Options, Restricted Stock, and Other Equity Arrangements

The treatment of options and stock appreciation rights under IRC Section 409A is significant. Fixing the dates of payment in advance, as would generally be required under IRC Section 409A, would change the ordinary operation of these arrangements, since payment occurs upon exercise. Options and stock appreciation rights on "service recipient stock" are excluded from IRC Section 409A if granted at fair market value.

It is important for anyone relying on this exemption to make sure that the applicable stock is "service recipient stock" and granted at fair market value.

Service recipient stock is generally any class of common stock, defined as common stock under IRC Section 305. It is stock of the corporation for which the service provider performs services, or of any corporation in a chain of corporations that has a controlling interest in the corporation for which services are provided. Service recipient stock cannot have a preference as to distributions, other than distributions of service recipient stock and distributions in liquidation. It also does not include any stock subject to a mandatory repurchase obligation (other than a right of first refusal) or a put or call right that is not a lapse restriction, if the stock price under such right or obligation is based on a measure other than fair market value.

It is also important to make sure that options are granted at *fair market value* on *the date of grant*. The final regulations have specific definitions of fair market value for both public or private companies, and include a definition of date of grant.

Finally, none of these exempt arrangements can have other "deferral features" that delay income inclusion. This could be, for example, a contractual provision that delays until a future year the transfer of stock upon exercise. Deferral features can also arise if the option's exercise date is extended. The final regulations do provide some relief for extension of the exercise date. An extension of the exercise period to the earlier of the original maximum term of the option or ten years from the grant date is not treated as an additional deferral.[10]

Companies with options or stock appreciation rights that are subject to IRC Section 409A because they were issued at a discount (this gives the options a deferral feature) generally have until December 31, 2007, to replace such options with nondiscounted options and rights and thus avoid IRC Section 409A, unless the option or right (1) was granted with respect to stock required to be registered under Security and Exchange Act of 1934 (Exchange Act) Section 12; (2) was granted to an officer subject to the reporting requirements of the Exchange Act; and (3) will cause the company to report a financial expense which was not timely reported on the corporation's financial statements. Employers that want to use this relief should review these rules carefully to ensure they are eligible.

Restricted stock is generally not considered deferred compensation, because it is governed by IRC Section 83. IRC Section 409A, however, would apply to promises to transfer in the future shares of restricted stock or shares obtained pursuant to an option.[11]

Foreign Plans

Generally, absent exemptions, amounts earned at home and abroad by US citizens, and amounts earned by US residents, are subject to US tax and thus potentially subject to IRC Section 409A. Absent exemptions, non-US citizens or residents with earnings outside the United States could also face problems under IRC Section 409A if they come to live in the United States and receive previously deferred amounts. Organizations with such employees need to review carefully Treasury Regulations Sections 1.409A-1(a)(3) and 1.409A-1(b)(8) for applicable exemptions.

For example, there are exemptions from IRC Section 409A to the extent deferrals with respect to compensation would have been excludable under a tax treaty or by statute (*e.g.*, Section 911 foreign earned income or IRC Section 933 (Puerto Rico residents)) if not deferred. Special exemptions apply to assist pay practices of employers with foreign operations and US-based employers with foreign employees, including deferrals under "broad-based foreign retirement plans" that meet certain conditions, contributions to foreign Social Security arrangements, limited *de minimis* amounts deferred by a nonresident alien under a foreign plan maintained by a foreign employer, and certain tax equalization payments.

Split-Dollar Life Insurance

Split-dollar life insurance arrangements divide premium payment obligations and insurance benefits (including, in some cases, cash values) between two parties. Independent from IRC Section 409A, the IRS revised the tax treatment of split-dollar life insurance with the issuance of final regulations in 2003. Certain split-dollar arrangements entered into on or before September 17, 2003, and not materially modified thereafter are eligible for special grandfather rules.

When the final Section 409A Treasury Regulations were issued, the IRS issued Notice 2007-34, which describes how split-dollar arrangements are treated under IRC Section 409A.[12] Death benefit only arrangements are not subject to IRC Section 409A. Also, split-dollar arrangements characterized as loans under the split-dollar rules generally are not subject to IRC Section 409A unless the loan can be waived, cancelled, or forgiven.

Arrangements that are taxed under the "economic benefit" characterization pursuant to IRC Section 61 can be subject to IRC Section 409A, unless they are death benefit only arrangements. Access to policy cash values, if not otherwise exempt as a short-term deferral, would be subject to IRC Section 409A. Notice 2007-34 explains how split-dollar contracts are bifurcated to identify these features, and also states that changes necessary to comply with IRC Section 409A will not constitute a modification for purposes of the split-dollar rules.

Tax-Exempt Entities

IRC Section 409A does not apply to Section 403(b) and Section 457(b) plans sponsored by tax-exempt entities, but it can apply to nonqualified deferred compensation arrangements sponsored by these entities, such as split-dollar arrangements or Section 457(f) plans. The final regulations state that amounts deferred under Section 457(f) plans and earnings may be exempt from IRC Section 409A under the short-term deferral exception, if these amounts are actually paid or included in income no later than the 15th day of the third month after the later of the employee or employer's taxable year in which the deferred amounts are no longer subject to a substantial risk of forfeiture.[13] Note, however, that the Preamble to the proposed regulations made it clear that the IRS does not consider vesting under a "rolling vesting" arrangement to constitute a substantial risk of forfeiture for purposes of IRC Section 409A.[14] Moreover, deferred earnings that are not included in income under IRC Section 457(f) when they vest would be subject to IRC Section 409A unless they independently satisfied an exemption.

Severance Plans and Reimbursement Arrangements

Special Rules for Separation Pay

The proposed regulations exempt from IRC Section 409A separation payments made in connection with an *involuntary* termination or a window program, to the extent that such payments do not exceed two times the employee's annual compensation or, if less, two times the limit on annual compensation that may be taken into account for qualified plan purposes under IRC Section 401(a)(17) (*i.e.*, twice $225,000 for calendar year 2007), and are made over a period of two or fewer years.[15] For example, if a separation pay plan provides that an employee will receive ten weeks of his or her weekly base salary of $2,000 a week upon a termination by the employer, starting immediately upon termination, under the employer's monthly pay schedule, the separation pay would be exempt from IRC Section 409A. This exemption should help many, but not all, severance pay programs. (Remember too that if a lump-sum severance payment is made immediately upon an involuntary severance, it may be considered a short-term deferral and not subject to IRC Section 409A for that reason.) An important change made in these regulations is to state that the separation pay exception applies to the *portion* of separation payments that meet the condition of the exemption. Thus, for example, if separation pay for 2007 equals $500,000 payable over one year, the first $450,000 would be exempt.

Another important change made in the final regulations was to deem an involuntary termination to include a termination "for good reason." Thus, certain "good reason" arrangements may be exempt from IRC Section 409A under the involuntary separation pay exception or the short-term deferral rule. The regulations state that "good reason" must be defined in the arrangement to require employer actions that result in a material negative change to the employee or service provider, and cannot be intended to circumvent IRC Section 409A. The regulations contain a safe harbor for good reason terminations requiring that:

- Separation from service must occur during a set period of time not to exceed two years after the occurrence of a material diminution in base compensation, authority, duties or responsibility, a material diminution of the budget over which service provider retains authority, a material change in the location where services are performed, or a material breach of the employment agreement;

- The amount, time, and form of payment must be substantially identical to payments resulting from the involuntary termination; and

- The service provider must be required to notify the service recipient within 90 days and the service recipient must be provided a cure period of at least 30 days.

The final regulations provide relief for separation pay arrangements that arise in the context of a "window program" if they otherwise meet the exemption for separation pay described above. A "window program" is defined as a program established by an employer to provide separation pay that is made available, for a limited period of time (of no more than 12 months), to employees who separate from service during that limited period. Although participation in a window program would typically involve a *voluntary* separation from service, the regulations treat such separations as *involuntary*. The regulations state that a program will *not* be considered a window program if the employer routinely provides similar separation pay in similar situations for substantially consecutive, limited periods of time.[16]

Other than in the context of window programs and terminations for "good reason," separation pay arrangements reached in the context of a *voluntary* termination will generally be subject to IRC Section 409A. The regulations do, however, contain exemptions for separation pay arrangements reached in connection with a bona fide collective bargaining agreement.[17]

Post-Separation Reimbursement Arrangements

Although the IRS refused to allow a general exclusion for all reimbursements paid at termination of employment, certain types of reimbursements related to severance arrangements are excluded from IRC Section 409A, whether the separation is voluntary or involuntary. These include:

1. Reimbursements that are otherwise excludible from gross income;
2. Reimbursements for expenses that the employee can deduct under IRC Section 162 or IRC Section 167 as business expenses incurred in connection with the performance of services (ignoring any applicable limitation based on adjusted gross income);
3. Certain outplacement expenses; and
4. Moving expenses, including certain expenses related to a loss on the sale of a primary residence.

These expenses can be in-kind benefits, or direct payments made by the employer to the person providing the goods or services to the terminated employee, if the provision of such in-kind benefits or direct payments would be treated as reimbursement arrangements if the employee had paid for such expenses and received reimbursement from the employer. They must be limited to amounts that a former employee has actually incurred as an expense.

Direct payments by the employer must be incurred and paid before the end of the *second* calendar year following the calendar year in which a termination occurs. For reimbursement of expenses incurred by the service provider, payment must be made not later than the end of the *third* year following separation from service (but the expenses must be incurred at the same time in-kind expenses are incurred, *i.e.*, before the end of the *second* calendar year).

Finally, the regulations have special rules that would allow otherwise taxable reimbursements of medical expenses to be provided over the COBRA continuation period. The final regulations also exclude "*de minimis*" payments that do not exceed the Section 402(g) limit in the aggregate during any given taxable year ($15,500 in 2007), but the Preamble makes it clear that once this exemption is used for a right or benefit, it cannot be used for additional benefits even if the full amount of the exclusion was not used.[18]

Other Reimbursements and Tax Gross-Ups

There are certain common reimbursement arrangements that are *not* specifically exempt from Section 409A, such as taxable medical payments or reimbursements that do not otherwise qualify for the exception described above, continued membership in country clubs or golf clubs, or continued use of an office or executive jet after termination. Such reimbursements are not exempt from IRC Section 409A, because the Treasury and the IRS believed they could provide for significant amounts of income over long periods of time, and thus must meet the Section 409A payment rules.

Under the regulations, however, many non-exempt reimbursement plans can be structured to meet the requirements of IRC Section 409A.[19] They must provide for a reimbursement of objectively determinable expenses incurred over an objectively prescribed period, where the amount of expenses incurred in one taxable year will not affect expenses or benefits in a different year. They must be paid on or before the last day of the service provider's taxable year following the taxable year in which the expense was incurred. Also, such benefits cannot be subject to liquidation or eligible to be exchanged for another benefit. Thus, a right to reimbursement for annual country club membership fees of $10,000 for each of three years to be reimbursed within 30 days of the annual bill would be a structure that met IRC Section 409A, but a right to reimbursement of *up to* $30,000 in fees over three years would not.

Similarly, a right to a tax gross-up payment or reimbursement for costs related to a tax audit can constitute deferred compensation subject to IRC Section 409A, but such a right can be structured to comply with IRC Section 409A if it is designated to be paid by the end of the taxable year following the year in which the taxes are remitted or paid, or if no taxes are paid, by the end of the taxable year after the audit or litigation is complete.

Other Exempt Arrangements

The regulations provide an exemption from IRC Section 409A for settlements of bona fide legal claims (including attorneys' fees). Certain indemnification payments are also exempt. Finally, educational benefits for the service provider (not his or her family) have a special exemption.

Restrictions and Limitations Imposed by IRC Section 409A

If a payment is subject to IRC Section 409A, the statute and regulations specify:

1. When elections to defer compensation can be made;
2. What type of payment events can be specified in a deferral election;
3. When payments can be changed or accelerated; and
4. Certain types of payments that must be delayed.

These rules are discussed below.

Deferral Elections

In General

Generally, IRC Section 409A requires that an employee must make a deferral election in the taxable year before the year in which he or she performs services. Deferral elections include an election as to the amount of deferral for an amount based on an objective formula, and the *time* and *form* of the payment. The regulations contain exceptions for initial deferral elections and performance-based compensation, both of which are discussed below. There are also special rules for newly negotiated severance pay, commission payments, compensation awards that require at least 12 months of service after the award is made, and awards based on fiscal year compensation.[20]

Initial Deferral Elections

"Newly eligible participants" may make an election during the first 30 days of eligibility to participate in a plan, but only with respect to services performed after the election. The terms of this exception must be reviewed carefully.

A participant is only "newly eligible" if he or she is newly eligible to participate in all arrangements required to be aggregated. For example, if an employee is already eligible to make elections under a non-elective account plan, and a new non-elective account plan is established, the employee will *not* be considered newly eligible for the second plan.

Eligibility means the ability to make a deferral, whether or not a deferral is actually made.

Special rules allow two categories of former employees to be treated as newly eligible if they return to work and rejoin the plan. Individuals who have been paid all previously deferred amounts and who were not eligible to participate for periods after the last payment can be treated as newly eligible. Also, rehired employees who have not been active participants or eligible to participate for 24 months can be treated as newly eligible, even if they have deferrals under the plan. However, note that these exceptions do not apply to "linked" excess plans discussed below; a participant is treated as newly eligible only once under those plans.[21]

An initial deferral election can only apply to amounts attributable to services performed after the election. This rule may be difficult to apply. Under a special rule, if the amount of compensation subject to the election is based on a specified performance period (*e.g.*, an annual bonus), the deferral election will be deemed to apply to compensation attributable to services provided after the election if the amount deferred is no more than the total amount of compensation for the performance period times a ratio of the remaining days of the performance period after the election over the total number of days in the performance period.

Performance-Based Compensation

Deferral elections with respect to performance-based compensation may be made no later than six months before the end of the performance period. "Performance-based compensation" is defined as compensation where the amount of, or entitlement to, such compensation is contingent on the satisfaction of a pre-established organizational or individual criteria relating to a performance period of at least 12 months. Under this definition, monthly bonuses or discretionary bonuses will not qualify as performance-based compensation (although these amounts may be able to meet other exceptions to IRCSection 409A). The regulations allow the portion of performance-based compensation that is combined with non-performance based compensation to be treated as performance-based, as long as (1) the portion of compensation that is performance-based is identified separately; and (2) the amount of performance-based compensation is determined independently from the non-performance-based compensation, (*e.g.*, a bonus of $100,000 paid after three years, with an additional $200,000 paid if sales reach a prescribed level after three years).[22]

Separation Pay Elections

If separation pay not otherwise exempt from IRC Section 409A is the subject of arms-length, bona fide negotiations at the time of separation from service, an initial deferral election may be made at any time up to the time the service provider obtains a legally binding right to the pay.

Commission Payments

Special rules apply to determine when services are performed for certain types of commissions. This, in turn, will affect when deferral elections can be made, since generally they must be made prior to the service periods after which the compensation is earned. For *sales commissions* as defined in the regulations, the service provider is deemed to perform services only in either (1) the taxable year in which an unrelated customer remits payment; or (2) if applied consistently to all similarly situated participants, the service provider's taxable year in which the sale occurs. Thus, in some cases, the election may be made in the same year that the activity of selling occurs. For *investment commissions* that meet the regulation's definition, services are deemed to be performed in the 12 month period immediately *preceding* the date on which the overall value of assets or accounts used to pay the commission is calculated.

Permissible Payment Schedules and Distribution Events

IRC Section 409A identifies the events that can trigger a distribution from a nonqualified deferred compensation plan. Those events are:

1. Separation from service;
2. Disability;
3. Death;
4. A specified time or pursuant to a fixed schedule;
5. A change of control; or
6. An unforeseeable emergency.

The regulations explain these terms in detail and how specified payment dates can be tied to them.[23]

General Rules for Payment Dates

Where the time of payment is based upon the occurrence of a specified event, a plan must provide that the payment is made on the date of that event, or on an objectively determinable date or year following the event. The payment date can be: (1) a specified period after the event that begins and ends in one taxable year of the service provider or that is a period of no more than 90 days, but the service provider cannot have control over the taxable year of payment; or (2) a specified taxable year in which or after the event occurs. The concept in the regulations is that the payment date be objectively determinable or nondiscretionary, and, in general, that there be no control over the taxable year of payments.

Because it may not always be administratively feasible to make a payment upon the exact date stated in a plan, a payment will be deemed to be made on a designated payment date if it is made on such date or a later date that ends in the taxable year of the designated date, or if later, the 15th day of the third month after the designated payment date. (But the employee cannot directly or indirectly control the taxable year of payment.) Similarly, despite the anti-acceleration rules of the statute, the final regulations provide that a payment made 30 or fewer days earlier than the specified date will be deemed made on that date. Thus, a payment scheduled to be made 60 days after disability could be made 45 days after the disability. In all of these cases, the selection of the payment date cannot be within the direct or indirect control of the service provider.

Certain exceptions also apply where a payment would result in material harm to the employer, such as a violation of securities law or contract provisions. Although a payment delay may be permitted where a genuine dispute arises with respect to an employee's rights to such pay, the IRS noted that the parties must act in good faith (*e.g.*, one cannot manufacture a bogus dispute to delay payment) and make reasonable, good faith efforts to pay an amount, in order to meet the requirements of IRC Section 409A.

A plan generally must provide one time and form of payment for each payment event.[24] For example, a plan cannot provide for alternative forms of severance pay—a lump-sum payment upon involuntary separation from service and installments for voluntary separation.

The regulations do allow some limited exceptions to this "one schedule per event" rule. For a payment event other than separation from service, alternate forms of payment can be made before a specified date or age. For example, a plan could allow a lump sum if a participant was disabled before age 55, and installments if disabled at or after age 55. For separation from service-related payments, separate payment schedules are permitted for (1) separation from service upon a change of control (if within two years); (2) separation from service before or after a specified date (or date and years of service), which could be related to age if desired; and (3) separation from service under circumstances other than (1) or (2). For example, an arrangement could provide that a lump sum be paid upon separation from service within one year after a change of control, but that installments are otherwise paid upon a separation from service.

A plan may provide for payment upon the lapse of a substantial risk of forfeiture in accordance with a fixed schedule that is objectively determinable based on the date the risk of forfeiture lapses. But the schedule must be fixed and any change is a change in time and form that must generally follow the Section 409A change rules. For example, a plan that requires two years of service or the occurrence of an IPO before the service provider is entitled to payment can provide that payment will be made on each of the first three anniversaries of the earlier of completion of the earlier of two years of service or the IPO.

Definitions of Payment Dates

Taxpayers must ensure that they use a definition of permissible payment events allowed in the regulations. These are discussed below.

Change of Control, Disability, or Death

The regulations define certain "change of control events" that will be deemed a permissible payment event. They are:

- *A change in the ownership of a corporation*, which is defined as an acquisition by a person or "group" of persons acting as a group of at least 50 percent of the fair market value or voting power of a corporation. This 50 percent can be a higher percentage specified in the plan.
- *A change in the effective control of a corporation*, which is defined as (1) the acquisition by a person or group of at least 30 percent (or a greater 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 (2) the replacement of a majority (or higher percentage specified in the plan) of the corporation's board of directors during a 12-month period, if the appointment or election is not endorsed by the majority of the prior board members; and
- *A change in ownership of a substantial portion of a corporation's assets*, defined as more than 40 percent (or a higher percentage specified in the plan) of a corporation's gross fair market value.

Disability

The regulation has a specific definition of disability that must be used. A person is disabled if he or she:

- Is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to last for a continuous period of not less than 12 months, or
- Is, by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continued period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the service provider's employer.

A plan does not need to provide payments upon all disabilities. A plan can provide that a service provider is deemed disabled if determined by the Social Security Administration or Railroad Retirement Board, or if determined to be disabled in accordance with a disability insurance program that uses the definition of disability described above.

Death

At least at this juncture, it appears that neither the IRS nor the Treasury believes a specific definition of death is required to avoid abuse of the Section 409A rules.

Separation from Service

The regulations provide very detailed rules to define a separation from service, as this event appears capable of manipulation.[25] Different rules apply for employees and independent contractors. Generally, the service provider must cease to provide services to all members of the controlled group of the entity for which he or she provides service (but substituting 50 percent for 80 percent for this purpose unless a percentage between 50 and 80 percent is specified in the plan). A service recipient may specify (on a consistent basis) that in the event of a sale of substantially all assets to an unrelated buyer (normally a separation of service), a service provider will not be deemed to have had a separation from service for purposes of IRC Section 409A, if the asset purchase is a bona fide third-party transaction and all similarly situated participants are treated consistently.

An employee separates from service upon death, retirement, or termination of employment. A leave of absence is only considered a separation from service (1) after a period of leave exceeding six months; and (2) if the individual is not provided with contractual or statutory re-employment rights. Termination of employment occurs if the facts and circumstances demonstrate that the employer and the employee reasonably anticipate that after a certain date (1) no further services will be provided; or (2) the level of services will decrease to no more than 20 percent of the level performed for the previous 36-month period (or full period of employment, if less). Other facts and circumstances that would demonstrate whether a termination has occurred are described in the regulations.[26]

An employee is presumed to have separated from service if his or her level of bona fide services is less than 20 percent of the level of the preceding 36 months, and is presumed not to have separated if his or her level of service exceeds 50 percent of the 36-month average. A special rule accommodates so-called phased retirement, by allowing a plan to specify a level of reduced employment of between 20 and 50 percent of services as constituting a separation from service.

If a person is an independent contractor rather than an employee the rules differ. A separation from service applies only upon the expiration of the service contract (or all contracts if more than one) that is a good faith and complete termination of the contractual relationship. If a follow-up or renewal contract is anticipated, then the separation has not occurred. The regulations have a safe harbor that deems a separation from service to occur if certain conditions are met, including a requirement that payments be delayed for 12 months after expiration of the contract or contracts.

Unforeseeable Emergencies

Payments can be made upon an unforeseeable emergency. This is defined as a severe financial hardship resulting from (1) an illness or accident of the service provider, his or her spouse, beneficiary, or dependent; (2) a casualty loss to the service provider's property (not otherwise covered by insurance); or (3) any other similar extraordinary or unforeseeable circumstances arising from events beyond the control of the service provider. This standard is stricter than the "hardship" standard used under IRC Section 401(k). For example, the need to pay college tuition or purchase a home are not unforeseeable emergencies although they may qualify as a 401(k) hardship.

The amount of payments must take into account the ability of the service provider to handle the emergency by liquidating other assets or insurance, or by ceasing deferrals in the nonqualified deferred compensation plan.[27] A plan may allow cancellation of a deferral election due to an unforeseeable emergency or a hardship distribution under the qualified 401(k) rules without violating the anti-acceleration rules.[28] This deferral election must be cancelled, not merely postponed. A service provider can decide not to elect to receive a payment in an emergency (this is not deemed to be an election) and the service recipient can retain discretion whether to allow the payment.

Substitution Rules

The final regulations clarify that people cannot manipulate IRC Section 409A by paying a "new" amount as a substitute for previously awarded deferred compensation. The payment of this new amount will be treated as a payment of the deferred compensation.[29] A forfeiture or voluntary relinquishment of deferred compensation is not treated as a payment, but no forfeiture or relinquishment is deemed to occur if a substitute amount is paid. Whether a payment is a substitute depends on facts and circumstances. Reductions or offsets of one payment for another are considered to be substitutes. Payments similar in amount to the relinquished or forfeited amounts are presumed to be substitutes unless the presumption is rebutted. This substitution rule should be considered carefully when pay or benefits are being renegotiated.

Changes in Payment Dates and Permitted Accelerations

With certain exceptions, once a deferral election is made, the ability of the parties to change a compensation arrangement to delay payment, or to change the form of payment, is limited and will usually require a delay in the receipt of deferred compensation. Generally,

- Such election may not take effect until at least 12 months after the date on which the election is made;
- In the case of an election related to a payment not made on account of disability, death, or the occurrence of an unforeseeable emergency, the plan requires that the payment with respect to which such election is made be deferred for a period of not less than five years from the date such payment would otherwise have been paid; and
- Any election related to a payment to be made at a specified time or pursuant to a fixed schedule may not be made less than 12 months prior to the date the payment is scheduled to be paid.

A "payment" is each separately identified amount to which a service provider is entitled to payment on a determinable date. The ability to elect installment payments is considered a single payment for purposes of these rules, but the final regulations allow a plan to specify that a series of installment payments is to be treated as a series of separate payments.[30] The regulations also contain rules explaining when taxpayers can treat actuarially equivalent life annuities as a single form of payment, thus allowing elections among such forms at any time prior to payment.[31]

As discussed above, under IRS transition guidance, deferral elections made in 2007 need not meet these 12-month/five year rules as long as the election does not (1) move income otherwise payable in 2007 to a later year; or (2) move income payable in a later year to 2007. The IRS has warned, however, that constructive receipt principles still apply to elections made under these transition rules.

IRC Section 409A also limits an employee's ability to *accelerate* payment of deferred compensation, except as provided in regulations. An acceleration includes a cancellation of a deferral election. Events that permit acceleration under prescribed circumstances include:

1. Compliance with domestic relations orders or certain conflict of interest rules;
2. Payment of employment and certain other taxes;
3. Unforeseeable emergencies;
4. Payment of amounts subject to inclusion under IRC Section 409A;
5. Certain disputes and offsets;
6. Cancellation of elections upon disability; and
7. Plan termination and liquidations.

The regulations also allow certain *de minimis* cashouts. The rules for unforeseeable emergencies are discussed above; certain other exceptions are discussed below.

Income Inclusion Under IRC Section 409A and Certain Employment and Withholding Taxes

A plan may authorize a payment of any amount required to be included in income due to a failure to meet the requirements of IRC Section 409A. A plan may authorize payment of FICA and employment taxes, as well as any income tax withholding amounts (but not the full tax itself) when taxes on a deferred amount are due. Similarly, the regulations allow a plan to authorize payments of any applicable withholding amounts (but not the amounts themselves) when employees of tax-exempt entities are required to include amounts in their income under Section 457(f).

Cashouts

Cashouts equal to or less than the current Section 402(g) limit may be authorized; these can be paid automatically or at the *service recipient's* discretion. The cashout must liquidate all of a service provider's interest in the plan (and any plan required to be aggregated).

Plan Terminations

A plan can liquidate its assets and make payment upon termination in limited circumstances:

- A plan can be terminated and liquidated if a corporate dissolution or bankruptcy liquidation of the service recipient occurs, but only if payments are made within a specified period of time.
- A plan can be terminated and liquidated within 30 days before, or 12 months after, a change of control, if all other plans aggregated with the plan are terminated for all persons affected by the change of control and payments are made as prescribed in the regulations.
- A plan can be terminated if all plans of the same type are terminated and (1) the termination does not occur proximate to a downturn in the employer's financial health; (2) payments other than those already scheduled are postponed for 12 months after the termination; (3) all payments are made within 24 months of the termination; and (4) no new arrangement of the same type is adopted for three years (the proposed regulations had imposed a five-year period).

Application of Election Rules to "Linked Plans"

IRC Section 409A affects common practices under "wrap around" or so-called "make-up" plans that give participants the opportunity to defer amounts in excess of the dollar limits permitted to be deferred under 401(k), 403(b), and qualified plans. Without special exceptions, certain qualified plan elections or activities which can affect the amount of, or the payment date for, nonqualified deferred compensation, would be deemed an impermissible deferral change or acceleration, but some relief is provided in the manner set forth in the regulations.[32] The major exception is for elections to make or change deferrals in a qualified plan or to make after-tax contributions to qualify for a match. Even if those elections change the amounts in a nonqualified plan, they will not be treated as an impermissible election or change to a nonqualified plan as long as the change is for no more than the amount allowed under IRC Section 402(g) plus the catch-up limit, if applicable. This Section 402(g) limit applies separately to elective and nonelective (including matching) contributions. In addition, the regulations state that (a) an amendment by the service recipient to reflect changes in statutory limits or to add or remove a benefit or reduce or increase benefits; or (b) an election by the service provider to receive or forego a subsidized benefit will not be deemed an impermissible deferral change or acceleration.

The regulations, and IRS Notice 2006-79, extend until the end of 2007 the ability of nonqualified linked plans to tie *payment* deferral elections to those made under qualified plans. After 2007, such plans must be "de-linked" for payment purposes. This means that by the end of 2007, nonqualified plans must be amended, and payment elections must be made, to establish an independent time and form of payment.

The Six-Month Delay Rule

If a "specified employee" in a corporation whose stock is publicly traded on an established securities market has a separation from service, payment of deferred compensation subject to IRC Section 409A must be delayed at least six months following the separation.[33] The Preamble to the regulations makes it clear that a company is considered "public" for purposes of the six-month delay rule even if its stock is publicly traded solely on a foreign exchange, or is traded on the US exchange solely as American Depository Receipt or Shares (ADRs).[34] This rule is perhaps the one most directly traceable to the Enron scandal; it was designed to prevent arrangements which allowed executives to take immediate severance pay before a company bankruptcy. However, it is much broader than that. It affects many standard severance arrangements and often can create cash-flow problems for terminating employees.

A specified employee is identified on an identification date (usually December 31) and treated as a specified employee on the "specified employee effective date" after the identification date (usually April 1). A specified employee is defined using the concepts of a "key employee" under the top-heavy rules of IRC Section 416. Generally, a specified employee is (1) an officer with compensation greater than the dollar limit for key employees on the identification date ($145,000 for an identification date of 12/31/07, then indexed); (2) a five percent owner of the employer; or (3) a one percent owner of the employer who earns more than $150,000 (indexed). Generally no more than the lesser of 50 employees or 10 percent of the controlled group of employees will be considered officers for this purpose.

Many companies are facing challenges identifying correctly all specified employees, particularly large companies with many officers and affiliates. The regulations allow a plan to describe an alternative group as "specified employees," if the method is reasonably designed to include all key employees, is objectively determinable, and does not result in more than 200 persons being classified as specified employees. However, if a specified employee is not identified under this method, and a prohibited payment is made to him or her, the Section 409A penalties will apply to him or her. Special rules also apply for identifying specified employees in mergers and acquisition situations or when a company first becomes a public company.

It is important to note that the six month delay rule does not apply to amounts that are not subject to IRC Section 409A or that are exempt from IRC Section 409A. For this purpose, one must distinguish between amounts exempt from IRC Section 409A (*e.g.*, short-term deferrals and separation pay and reimbursements of certain separation payments that meet exemptions from IRC Section 409A), and amounts that are subject to IRC Section 409A but have the benefit of special rules (*e.g.*, nonexempt reimbursements, performance-based compensation).

Transition Rules, Reporting, and Documentation Requirements

Transition Rules Affecting Operations

As noted above, IRC Section 409A generally became effective in 2005, but taxpayers had until the end of 2007 to modify and adapt their arrangements to meet the requirements of the final regulations, which were issued in April 2007. Prior to 2008, taxpayers had to comply with the statute in good faith based on applicable guidance.

Taxpayers need to look carefully at operational transition rules, some of which were discussed above. For example, the rule that subsequent deferral elections occur at least a year in advance and extend the elected payout for at least five years, does not apply until 2008, as long as the election does not move 2007 income into 2008, or move later income into 2007. Special rules apply to certain stock rights issued before April 10, 2007 and treated as service recipient stock under a good faith interpretation of the statute; certain of these rights may not have to be changed until exercised, terminated, or modified. Noncompliant rights issued on or after April 10 will have to be changed. Special rules also apply to payments made to persons in pay status and pre-April 10, 2007 performance-based compensation elections that do not meet final regulations. There are also transition rules for inadvertently "discounted" stock options. All such special rules have specific requirements that must be met and need to be reviewed in light of the individual arrangement involved.

Reporting Requirements

The American Jobs Creation Act requires that the amount of nonqualified deferred compensation (whether or not included in income), as well as any amounts that are included in income under IRC Section 409A, be reported. IRS Notice 2006-100 provided some reporting transition relief with respect to these requirements and summarized prior guidance on the issue.[35] The amounts of deferred income subject to IRC Section 409A for each affected individual for 2005 or 2006 did not need to be reported. But payments that violated IRC Section 409A had to be reported. The final regulations do not discuss income inclusion issues, but state that further transitional guidance may be forthcoming.

Plan Documentation

The plan documentation rules may be the most significant tasks for persons attempting to comply with IRC Section 409A. Generally, all applicable plans and arrangements must be amended to comply with IRC Section 409A on or before December 31, 2007. The Treasury Department and the IRS do not plan to publish model amendments.

The final regulations state that documents do not need to be made compliant with IRC Section 409A with respect to amounts deferred that were paid completely on or before December 31, 2007. (This differs from the normal practice with respect to qualified plans.) But taxpayers must be able to demonstrate operational compliance with IRC Section 409A. Although the regulations are not specific, it is likely that election forms, agreements, and items like contemporaneous emails may suffice for this purpose.

The regulations define what constitutes an acceptable plan or arrangement and when it must be established.[36] Generally, plans must show the material terms of the plan in writing, although more than one document may be used. These material terms must be in place by the end of the taxable year of the service provider in which the legally binding right implies or with respect to an amount not payable in the year immediately following the taxable year, by the 15th day of the third month of the subsequent year.

Plans must specify the following:

- The amount (or method or formula) of deferred compensation be paid under the plan;
- The conditions for payment and the form of payment (*e.g.*, payment schedule);
- If applicable, the conditions for making an initial deferral election, which must e included on or before the date the applicable election is irrevocable;
- If applicable, the conditions for making subsequent deferral elections, which must be included on or before the date the election must be irrevocable;
- If applicable, the application of the six-month delay rules, which must be included by the time the service provider qualifies

as a “specified employee.” It appears that a list of specified employees must be maintained for that purpose.

Generally the plan is not required to specify the conditions under which the permitted accelerated payments are made except as required under the Section 409A regulations. However, the employer still must show these permitted accelerated payments are in compliance with IRC Section 409A.

Companies often use a savings clause in their documents stating that each plan provision will be interpreted in compliance with applicable law and that any inconsistent provisions are disregarded. Many companies thought to use this practice for IRC Section 409A. But final regulations state that if an arrangement fails to meet the requirements of IRC Section 409A or contain necessary terms, the arrangement will violate IRC Section 409A regardless of whether it contains such a clause. Some commentators have nonetheless suggested that clause stating that a plan will be interpreted to comply with IRC Section 409A might be helpful in certain cases, even if it would not solve the problem of missing or impermissible plan provisions.

CONCLUSION

The publication of the final Section 409A regulations places taxpayers in the position of battle-weary Britons, who, on November 10, 1942, listening to Winston Churchill announce the British victory in Northern Africa over Rommel’s army, were told that “[t]his is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning.”

Taxpayers will have to respond to the challenge with patience and care, as service recipients finalize documentation in accordance with these myriad rules and explain these rules to all affected service providers.

NOTES

1. *See* Notice 2005-1, 2005-1 C.B. 274, and 70 *Fed. Reg*. 57930 (October 4, 2005). The other six pieces of guidance are:

   1. Notice 2005-94, 2005-2 C.B. 1208 (transition rules on 2005 reporting and withholding);
   2. Notice 2006-4, 2006-3 I.R.B. 307 (transition guidance for stock rights);
   3. Notice 2006-33, 2006-15 I.R.B. 754 (transition rules for certain foreign trusts);
   4. Notice 2006-64, 2006-29 I.R.B. 88 (federal ethics requirements);
   5. Notice 2006-79, 2006-93 I.R.B. 763 (transition relief); and

6. Notice 2006-100, 2006-51 I.R.B. 1109 (2005 and 2006 reporting and withholding obligations).

2. Treas. Reg. § 1.409A-6(a)(4).

3. *See* IRC § 409A(a)(1).

4. Treas. Reg. § 1.409A-1(c)(3)(viii).

5. Treas. Reg. §§ 1.409A-1(a), 1.409A-1(b).

6. Treas. Reg. § 1.409A-1(g).

7. See Notice 2005-1, *supra,* at Q&A-7.

8. Treas. Reg. §§ 1.409A-1(a)(3), 1.409A-1(a)(5).

9. Treas. Reg. § 1.409A-1(b)(4).

10. Treas. Reg. §§ 1.409A-1(b)(5)(i)(D), 1.409A-1(b)(5)(v)(C).

11. Treas. Reg. § 1.409A-1(b)(6).

12. IRS Notices 2007-34, 2007-17, I.R.B. 996.

13. *See* Preamble 72 *Fed. Reg.* 19234–19235.

14. *See* 70 *Fed. Reg.* 57930, 57945 (Oct. 4, 2005).

15. Treas. Reg. § 1.409A-1(b)(9)(iii).

16. Treas. Reg. § 1.409A-1(b)(9)(v).

17. Treas. Reg. § 1.409A-1(b)(9)(ii).

18. 72 *Fed. Reg.* §§ 19248–19249 (April 17, 2007).

19. *See* Treas. Reg. §§ 1.409A-3(i)(1)(iv), (v).

20. *See* Treas. Reg. §§ 1.409A-2(a)(5)–(11).

21. Treas. Reg. §§ 1.409A-2(a)(7)(ii), (iii).

22. Treas. Reg. § 1.409A-2(a)(8).

23. Treas. Reg. §§ 1.409A-3(a), (b).

24. Treas. Reg. § 1.409A-3(c).

25. Treas. Reg. § 1.409A-1(h).

26. Treas. Reg. § 1.409A-1(h).

27. Treas. Reg. § 1.409A-3(i)(3)(ii).

28. Treas. Reg. § 1.409A-3(j)(4)(viii).

29. Treas. Reg. § 1.409A-3(f).

30. Treas. Reg. § 1.409A-2(b)(2)(i).

31. Treas. Reg. § 1.409A-2(b)(2)(ii).

32. Treas. Reg. § 1.409A-3(h)(3).

33. Treas. Reg. § 1.409A-3(i)(2). The term "specified employee" is generally defined in accordance with IRC § 416(i).

34. 72 *Fed. Reg.* 19261.

35. IRS Notice 2006-100, 51 I.R.B. 1109.

36. Treas. Reg. § 1.409A-1(c).

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