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Employee Benefits Bulletin

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READY, SET, ~~GO~~ ... READY, SET ... GO!!! IRS DEFERS AMENDMENT DEADLINES FOR DEFERRED COMPENSATION PLANS

In late 2004, Congress enacted the American Jobs Creation Act, which folded new Section 409A of the Internal Revenue Code into the deferred compensation tax mix. Written to cure perceived abuse by Enron management of nonqualified deferred compensation plans, Section 409A substantially revised the tax rules relating to nonqualified deferred compensation arrangements and also vastly expanded the universe of arrangements that are treated as deferred compensation plans.

The statutory rules are complex and include some new and vague concepts, so it was certain from the outset that extensive regulations would be needed for plans to conform to the new requirements. Indeed, Congress directed the Department of Treasury to release guidance within 60 days of the Act's passage. In a newsletter we wrote shortly after Congress created Section 409A, we noted that most observers expected the guidance to include generous transition relief and that plan amendments would probably not be required during the first year.

Severance pay plans, certain performance-based plans, and certain types of stock plans are all within the scope of new Section 409A.

Some guidance was quickly issued, and proposed regulations were promulgated in October of 2005. The proposed regulations ran 238 pages and included an effective date of January 1, 2007, for documentary compliance (along with various and important transition relief through December 31, 2006). The proposed regulations drew a multitude of comments critiquing, among other things, the regulations' exceedingly broad coverage, an occasionally punitive nature, and gaps that would greatly complicate and sometimes essentially bar many common and non-abusive types of compensation arrangements.

The government eventually set back the regulations' effective date to January 1, 2008 (and also extended transition relief), with the belief that the final regulations would be published at least sometime in 2006 and thus would provide ample time for employers to comply with the complex regulatory rules and concepts. The final regulations did not, however, appear until April of 2007 and the government, yielding to pressure from employers and their lawyers, accountants, and consultants, ultimately extended the effective date for documentary compliance to January 1, 2009, and also extended by a year various transition relief.

In doing so, the Department of Treasury let it be known, at conferences and talks, that there would be no further extensions. Until the effective date, good-faith compliance with Section 409A will largely suffice. For this purpose, employers may rely on the final regulations but may no longer rely on the proposed regulations.

This article will provide a bit of historical context for Section 409A, will describe its basic provisions as seen through the lens of the final regulations, and will conclude with a list of what most businesses should be doing to prepare themselves for the January 1, 2009, moment of reckoning.

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I. Some Background and Historical Context

Note: this is intended as a broad summary of pre-409A law on deferred compensation issues. It is not, however, intended as a primer on such rules, which indeed were complex and have been the subject of treatise writers.

A. Law of Nonqualified Deferred Compensation Before 409A

The tax treatment of participants in nonqualified deferred compensation arrangements had long been found in the intersection of basic tax accounting principles, administrative rulings, judicial holdings, and statutory rules (primarily Internal Revenue Code Section 83). The three key overarching doctrines were those of constructive receipt, economic benefit, and the effect of forfeiture conditions, each of which we will briefly summarize below. Also discussed below is the "haircut" or acceleration principle under pre-Section 409A law.

1. Constructive Receipt

Under the constructive receipt doctrine, a person has current income for money or property to be paid in the future if the person receives it "constructively." Thus, if a person after providing services asks her employer to hold on to some of her compensation until some future tax period, she will nevertheless have taxable income in the year she provided services, notwithstanding the deferred receipt. If, on the other hand, the worker and employer agree to have compensation for services deferred to a future taxable year before the services are rendered, the deferred payments will be taxable income in the year actually received. Administrative rulings and case law filled in many details about when and how deferral elections had to be made, and different rules applied to bonuses and regular salary.

2. Economic Benefit

Under the economic benefit doctrine, an individual will recognize income in the year in which he enjoys the economic benefit of property, even if the property has not been legally and finally transferred to him. Thus, for example, if an employer pays money into a trust to secure the employer's promise to deferred compensation already rendered, the employee will recognize income. In an important limitation of this rule, the IRS has permitted the creation of the so-called rabbi trust (so named because its first reported use was by a congregation that set up such a trust for its rabbi), which remains subject to the claims of the creditors of the employer in the event of bankruptcy or insolvency.

3. Substantial Forfeiture Condition

In what is actually an application of the constructive receipt doctrine, the tax law (and in particular Section 83 of the Internal Revenue Code) provides that an employee does not generally recognize taxable income if the taxpayer receives property subject to a substantial forfeiture condition. Rather, the taxpayer will have income in the year when the forfeiture condition lapses.

A number of nonqualified deferred compensation plans included "acceleration" provisions that would allow an employee to speed up the actual receipt of compensation from such a plan, subject to a 10% penalty (known as the "10 percent haircut"). For example, a plan might provide for payment of an amount five years after services are rendered, but the employee has the right to elect earlier payment (subject to the haircut). This was not considered a case of constructive receipt because, pursuant to IRS guidance, the risk of a 10% forfeiture is substantial enough to avoid immediate recognition of income. Section 409A eliminates this strategy, which, as we note below, was abused by some executives, including executives of Enron Corporation.

B. The Climate Leading to Enactment of Section 409A

So why did the tax-hostile and business-friendly Congress of 2004 decide to rein in the nonqualified deferred compensation landscape? There is, of course, no single answer. To some extent the answer might lie in the perception that certain IRS-approved positions on deferred compensation arrangements (such as the rabbi trust rules) were transmogrified into vehicles of at least arguable tax abuse. In addition, an influential publication in circulation at that time suggested that nonqualified deferred compensation arrangements are sufficiently tax-favored to undermine, for some businesses, the attractiveness of qualified plans, which receive beneficial tax treatment only if structured in a way to meaningfully cover rank and file employees.

But as with many financial reforms during the last five years, the impetus was provided primarily by the collapse of Enron, whose executives used haircut provisions to accelerate payments from Enron's deferred compensation plans, even as Enron was failing and leaving its stockholders and rank and file employees high and dry. The image was of rats, and captains of industry, bailing out of a sinking ship (and taking as much cargo with them as possible). Some in Congress found this a tad unseemly and resolved to prevent its repetition. Section 409A was their answer.

Of course, and perhaps unfortunately, Section 409A goes far beyond remedying the acceleration problem and will affect the design of virtually every arrangement that results in deferral of compensation, including some arrangements that were not previously conceptualized as involving deferred compensation.

II. Section 409A and its Regulations

A. Statutory Overview

The basic gist of Section 409A is this: an employee* will recognize income in the year the employee earns it, unless income is deferred under a Section 409A compliant plan. Amounts deferred for tax purposes under other plans are subject not only to income tax, but also to a 20% excise tax and interest.

This raises two fundamental issues: what types of arrangements are subject to Section 409A, and what rules must such an arrangement satisfy to comply with the section?

Section 409A, by its terms, covers any arrangement that defers compensation beyond the taxable year in which it is earned, with certain statutory exceptions, including qualified plans, (bona fide) vacation and sick-leave plans, compensatory time plans, disability pay plans, and death benefit plans. In addition, the Secretary of Treasury has the authority to exempt arrangements that "will not result in an improper deferral of United States tax and will not result in assets being effectively beyond the reach of creditors."

The definition covers plans that previously have not been regarded as deferred compensation arrangements and were generally regarded more benignly than what we might think of as traditional nonqualified deferred compensation arrangements. Severance pay plans, certain performance-based plans, and certain types of stock plans are all within the scope of new Section 409A. By regulation, however, certain severance plans are excluded from Section 409A; certain plans are also grandfathered under the former legal regime, if benefits were accrued and vested before 2005. The regulations also carve out exemptions for certain other types of plans that can result in some deferral of income.

A participant in a plan that is subject to Section 409A is subject to strict rules governing when elections may be made, as well as limitations on the form and timing of distributions. Generally speaking, the primary rule under Section 409A is that elections must be made before

*Section 409A applies generally to "service providers," including employees, independent contractors, and non-employee corporate directors. For purposes of this article, the term "employee" encompasses this broad category of service providers.

the year in which the compensation is earned, or (if later) within 30 days of when an employee first becomes eligible to participate in the plan. There is also a special rule for performance-based deferred compensation, which permits a later election if certain conditions are satisfied.

The final regulations are not intended as a quick read; they run just a smidgeon under 400 dense pages

Distributions are only permitted on the occurrence of one of six types of events: (i) a specified time designated at the time of initial election; (ii) separation from service; (iii) a change in control of the employer; (iv) disability; (v) death; (vi) an unforeseeable emergency. For "key employees" of corporations whose shares are publicly traded, distributions may not occur until after six months following a separation from service. This limitation is designed to prevent such employees from taking the money and running.

A participant may, subject to certain conditions, change a distribution event or form of payment. Such an election cannot take effect for at least 12 months after the election is made, and, except for distributions made because of death, disability, or unforeseeable financial emergency, the first payment under the election must be deferred for a period of at least five years from the date the payment would otherwise have been made. In addition, payments may not be accelerated—no haircuts, not even just a little off the top.

B. An Introduction to the Regulations

The final regulations are not intended as a quick read; they run just a smidgeon under 400 dense pages. For the most part, the regulations attempt to provide hundreds of clear, discrete rules and definitions and safe harbors, rather than broad, general provisions. The detail in the regulations can, indeed, be stunning. While it should be relatively easy to design plain vanilla plans from the regulations, plans that are custom designed may be difficult to coordinate with the regulations.

The real problems with the regulations, however, are likely to reside in four particulars:

- the regulations' broad definition of plans and tightly drawn exceptions make it likely that some employers will inadvertently create arrangements subject to Section 409A, and inadvertence in creation will almost certainly mean noncompliance with the section's requirements;
- the regulations aggregate plans of similar types, so a problem with one plan in one of these mandatory aggregation groups can sink other plans in the group that would otherwise be compliant;
- the regulations require that all material plan terms be written and do not allow savings clauses, so a non-compliant plan document can be problematic even if administered in accordance with the statute;
- the regulations may make it difficult for firms whose stock is not publicly traded to offer stock options because of stock valuation issues.

Indeed, given the Talmudic complexity of the regulations, the term "rabbi trust" may, in the future, denote trusts carefully drafted by rabbinical-type lawyers.

The IRS is currently working on guidance on penalties. We can hope that the penalties for small, inadvertent drafting and operational failures will be proportionate to the violation. Along these lines, in December of 2007 the IRS issued a notice that includes a reasonable correction program for certain unintentional operational failures. The IRS will not treat certain unintentional operational failures as violations if they are corrected in the year of failure. A special transition rule will allow correction within two years for pre-2010 failures involving amounts less than the Section 402(g) deferral amount, although this rule protects the integrity of the plan as a whole; the penalties can still apply to the actual compensation involved in the failure.

C. Regulatory Highlights

In this section, we briefly review some of the highlights of the final regulations.

1. What is a Plan?

The regulations cover plans that provide deferred compensation. A plan provides deferred compensation if, under the plan (which for this purpose might be an unwritten program), a participant has a legally binding right during the year to compensation, all or a part of which is payable in a subsequent taxable year. The regulations do not provide much detail about when an obligation is a "legally binding right," but a legally binding right can arise even though the right is subject to a forfeiture condition. The regulations indicate, though, that the employee does not have a legally binding right if the plan sponsor has complete discretionary control of whether the benefit will be paid or how much will be paid.

The regulations exclude several types of compensation arrangements from Section 409A's requirements. In addition to the statutory exemptions (noted in Part A above), the regulations exclude:

a. Short-term deferral payments, which are payments made within 2 ½ months after the year the payments accrued or, if later, became nonforfeitable. The payments count if the payments are made within the short-term deferral period or if the plan specifies a conforming payment date and payment is made within the year including the payment date.

b. Payments for involuntary termination (including voluntary termination for "good reason") or "window period" payments during a reduction in force. The payments must be completed by the end of the second year following the termination and cannot exceed twice the employee's annual pay rate, which itself is subject to the compensation cap under Section 401(a)(17) of the Internal Revenue Code. For 2008, the cap is $230,000, so the maximum payment over the two-year period for a termination in 2008 would be $460,000.

c. Stock options are exempt from Section 409A if they are issued on common stock of the company (or of certain related entities) for whom the employee performed services. In addition, the exercise price must be equal to or greater than the fair market value of the underlying stock on the day the company grants the option, and the option itself must not have deferral features beyond those inherent in a straight stock option.

The regulations include elaborate rules governing stock option programs. One of the controversial issues in the proposed regulations was whether options for non-publicly traded stock would be compliant if the option price was based on a good faith valuation. Several comments suggested this approach, but it was not adopted in the final regulations. The final regulations, however, endorse several approaches to valuation of non-publicly traded stock and indicate that the IRS will

not challenge the valuation if one of those methods is used unless the valuation is "grossly unreasonable." Some have argued that the combination of the permissible valuations with the "gross unreasonableness standard" is the functional equivalent to a good faith standard. Of course, gross unreasonableness might be in the eye of the beholder, which could be problematic for non-publicly traded stock.

d. Stock appreciation rights are also exempt if they satisfy conditions similar to those that stock options must meet. The value of the right can be no greater than the appreciation of the stock from the grant of the appreciation rights, the measuring stock must be common stock, and there can be no further deferral once the employee exercises the appreciation right.

2. Plan Aggregation

The regulations create nine categories of plans: (i) elective deferral plans; (ii) account balance plans (essentially defined contribution plans); (iii) non-account balance plans (essentially defined benefit plans); (iv) split dollar life insurance arrangements; (v) non-exempt stock rights plans; (vi) expense reimbursement or in-kind benefit plans; (vii) separation pay plans involving involuntary separations or window programs (that turn out to be non-exempt); (viii) certain plans covering non-resident aliens; (ix) all other plans.

Every plan is assigned to one of these categories and all the plans within a single category are aggregated. A failure of any plan within a category to satisfy section 409A will impact all of the plans within that category. This is, essentially, a principle of collective guilt, and it drew strong critiques from those who commented on the proposed regulations.

3. Written Plan; Savings Clause Not Permitted

Although an employer may have an unwritten deferred compensation plan, the unwritten plan will fail to be section 409A compliant, since the regulations require that the plan document include all the material terms of the plan. These terms include, among others, the amount of deferred compensation to be paid to the employee, the applicable payment triggers, and the six-month delay requirement for key employees in publicly traded companies.

As already noted, the regulations indicate that a savings clause in the written document will not salvage an otherwise non-conforming plan.

4. Initial Election Rules

At the time of the initial election of deferred compensation, the employee must designate the triggering event, how long after the triggering event distributions will actually commence, and whether payments will be made in a lump sum or as installments or annuities. There are only limited choices that can remain open after the initial election. First, the initial election need not designate whether the payments will be made in cash or property. Second, the form of an annuity may be decided up to the annuity starting date, so long as the form selected does not change the annuity's actuarial value. Third, a rabbi trust may be set up after the initial election so long as the employer is not in financial distress at the time.

When do elections have to be made? Although the general rule is that elections must be made before the start of the year in which the deferred compensation is earned, the statute and regulations are replete with special rules for special situations. These include:

a. Performance pay: When compensation is performance based and references a period of at least twelve months, an employee's election must be made on the earlier of the date six months before the end of the performance period, or the time when the amount paid becomes certain. (The performance pay rules in the regulations are lengthy, detailed and can in certain situations be complicated.)

b. Initial participation in a plan: An employee generally can make an election within 30 days of the initial date of plan eligibility, to defer compensation earned after the election. For this purpose, initial participation in a plan means initial participation in a particular category of plan. So if an employee has already participated, for example, in one account plan, the election will not be available for initial participation in a different account plan.

c. Initial participation in an excess benefit plan: An employee is given more flexibility upon initial participation in a non-elective excess benefit plan. Here the employee has 30 days after the end of the first year in which she accrues a benefit. This election is available only once, even if the employee later initially participates in a different category of excess benefit plan (initial participation in a defined benefit excess plan will prevent the election later being made for initial participation in a defined contribution plan).

d. Negotiated severance pay: If non-exempt severance pay is negotiated, the participant may make an election as part of agreement even though it might relate to past services. The participant cannot, of course, have had a legally binding right to the pay beforehand and the severance pay cannot be a substitute for previously deferred compensation.

e. A non-resident alien becomes a resident: The regulations allow an employee who becomes a resident alien until the end of the year to make an election.

f. Links to qualified elective deferral plans: The regulations do not consider an election to be changed merely because the amount deferred is linked to the amount voluntarily deferred to a qualified plan permitting elective deferrals.

5. Distribution Triggers

As already noted, a Section 409A plan may generally make distributions following one of six distribution triggers. (A plan may also combine triggers, providing that distribution will be made on the earliest, or latest, of two or more designated triggering events.) Among the significant regulatory positions on the six triggers are the following:

a. Date Certain: One of the possible triggering events for a distribution is a date certain. The regulations take the view that a date certain must be predictable at the time of the initial election. Thus, a date that is not certain at the time of the initial election, e.g., the date I get married, will not satisfy Section 409A.

b. Change in Control: A change in ownership can occur if there is an ownership change, a change in effective control, or a sale of substantial assets. The change, however, must affect either the entity for which the participant works or a company above it in an ownership chain.

6. Acceleration of Payment Dates

Generally a plan may not accelerate payments, even if the acceleration results in forfeiture of part of the benefit, but the regulations recognize two exceptions. First, a participant can cash out all of her benefits (within a plan category) if the amount is not greater than the amount that could be deferred in the relevant year to a 401(k) plan. This type of acceleration provision can be mandatory or discretionary.

A plan may also establish rules that permit a participant to cash out all remaining installment payments, in accordance with plan terms.

7. Plan Terminations

A company may terminate a plan and then make benefit distributions, but only if certain alternative plan termination conditions are met, including

(i) all plans in the relevant category are terminated;

(ii) distributions must be made within a 12 month window beginning 12 months after the termination;

(iii) the plan sponsor must not be having a downturn in financial health.

In addition, the plan sponsor may not establish a new plan in the terminated plan category for a three-year period. Other alternatives that permit plan termination include a change in control; or a liquidation of the employer.

8. Delaying Distributions

The statute includes rules permitting a delay of distributions previously elected. Certain timing rules have to be met: an election to postpone is not effective for 12 months and must delay distribution for at least five years (with exceptions for death, disability or unforeseen emergency). The regulations include reasonable interpretations of these requirements and permit an annuity to be converted to a lump sum or (vice versa), so long as the timing requirements are met.

The regulations also include rules that permit some delays because of economic or administrative problems.

9. Rules for Independent Contractors

The regulations include special rules for independent contractors and corporate directors, including when they are considered to have separated from service.

III. Getting Ready Again: What To Do and When to Do It

By extending the deadline to create compliant written plan documentation and also extending certain transition rules, the IRS has provided relief to many businesses by allowing them to complete the many tasks that section 409A set before them. For several businesses that delayed getting started on compliance or were unaware of the extent to which the new requirements had to be implemented by the end of 2007, the IRS has given a true second chance. Second chances come seldom enough in life and should be availed of when they come our way.

So what should businesses do? And what should they not do?

Let's start with the second question. They should not assume that Section 409A does not apply to them because they do not provide employees with deferred compensation or because their deferred compensation agreements are simple and non-abusive. Section 409A has such broad scope—extending to compensation arrangements that have not traditionally been thought of as involving tax-significant deferral—and has such specific requirements, that every business must at least affirmatively review whether it applies to them.

And what should businesses do immediately? The first and most important step is to inventory (and collect) all compensation arrangements, policies, and practices that cover or apply to employees, independent contractors, and directors. These run the gamut from stock grants to severance policies and practices, from bonus policies to performance-based compensation.

These arrangements, policies, and practices must then be reviewed to determine whether they might be subject to section 409A. Some will fall into exempt categories, some will be easily characterized as subject to section 409A, and some will be in a twilight zone where close analysis is necessary. The arrangements under Section 409A must then be grouped into their respective categories. Plans that are unwritten must be put into written form, and plans that are written must be reviewed to determine what plan amendments are needed.

Certain transition relief decisions, which allow certain modifications of existing plans, must be considered. New policies and written forms must be created and their substance and their procedures must be communicated to employees. Keep in mind that good faith operational compliance with Section 409A is already required.

This is a significant project, which will take several months of attention. And the clock is already ticking.

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