

WHAT THE CLOSELY-HELD EMPLOYER NEEDS TO KNOW ABOUT THE NEW CODE SECTION 409A NONQUALIFIED DEFERRED COMPENSATION RULES

by Mark Altieri

Overview

In General. Most practitioners and business people are aware that a new and sweeping provision, Section 409A, was recently added to the Internal Revenue Code (unless otherwise noted, "Section" will refer to sections of the Internal Revenue Code). These new rules (we will call them the Section 409A Rules) potentially impact every "nonqualified" arrangement that defers the receipt of compensation income to a year later than that in which it was earned.

Generally, the Section 409A Rules are applicable to compensation deferred under a nonqualified deferred compensation arrangement (a DCA) after December 31, 2004. Since the advent of Section 409A in October of 2004 (the American Jobs Creation Act of 2004), the IRS and Treasury Department have provided clarifying notices and proposed regulations that will be elaborated on below.

Business newspapers, executive newsletters, journals and periodicals have been awash with summaries of the Section 409A Rules, but there is little in the literature that separates the many detailed rules that are more applicable to the publicly-traded employer from those of particular interest to the closely-held employer. The purpose of this article will be to explain in practical language what the Section 409A Rules mean to DCAs more likely to be maintained by the closely-held employer for its key employees and to highlight any necessary amendments.

Penalty for Noncompliance. Section 409A imposes a tax acceleration and a significant penalty to the extent that the DCA experiences a "plan failure" (described below) and the plan benefits to be paid in the future are not then subject to a "substantial risk of forfeiture" (an SROF). We will discuss what constitutes an SROF under Section 409A below, but for now we will note that a contractual requirement to render substantial future services before benefits vest will constitute an SROF. Upon a plan failure,

absent an ongoing SROF, not only will all deferred compensation (plus income attributable to it) be accelerated into income, but a 20% penalty tax will be imposed in that year.

Relevant Authority. We currently have a number of primary and secondary authority sources to help understand the breadth of Section 409A. The IRS has provided guidance in the form of IRS Notices. IRS Notice 2005 1 is the most helpful and relevant and was issued by the IRS in December 2004 to provide a much needed interpretation of Section 409A. In responding to comments from the public on Notice 2005 1, and to provide additional and new guidance, the Treasury Department issued proposed regulations on Section 409A in September 2005 (the Proposed Regulations). Final regulations are expected before the end of the year and are not expected to effect the issues elaborated on in this article (anticipate the final regulations to be virtually identical to the Proposed Regulations referenced herein).

The Intent of New Law. As we will see, the new law under Section 409A is generally applicable to DCAs maintained by closely held employers. However, the true abuse that Section 409A was intended to blunt occurred with more sophisticated DCAs, where manipulation as to the initial deferral decision and the timing of benefit payments was commonplace before 2005. For DCAs maintained by closely held employers that are traditional nonqualified deferred compensation plans, the new rules typically will not require substantial amendments. This is because the terms of these closely held plans may already largely follow the requirements laid out under the Section 409A Rules (that is, payments under the plans will not occur until a specified date, separation from service, death, or disability, and there is no mechanism under the plan to either accelerate or further defer payment of the scheduled deferred compensation). Still, the closely held DCA will need to conform its definition of these triggering events to those required under the Section 409A Rules. Additionally, as will be noted, the definition of what constitutes a DCA is extremely broad and goes well beyond traditional nonqualified deferred compensation arrangements to potentially ensnare employment, severance and bonus agreements. It is these latter agreements that are a potential trap for the closely-held

employer, even among those somewhat well-versed on the Section 409A implication with regard to traditional nonqualified deferred compensation arrangements.

Relevant Timeframe for Section 409A Compliance. Section 409A is generally applicable to income deferred after 2004. Notice 2005-1 originally required that amendments to DCAs to bring them into general conformity with Section 409A were to be made on or before December 31, 2005. The Proposed Regulations extended the amendment deadline to December 31, 2006. Lastly, recently issued Notice 2006-79 has extended the amendment deadline to December 31, 2007.

The Conceptually Difficult Multi-Pronged Analysis of Section 409A

What makes comprehension of Section 409A particularly difficult is the three-pronged nature of the necessary analysis. The first step is to determine that an arrangement to defer compensation is a DCA under Section 409A. Having determined that a deferral is a DCA, the second step is a determination as to whether the plan benefits are subject to an SROF. If not, the final determination is whether the DCA, at that time, inherently suffers from a "plan failure". The convergence of these three events invokes the income acceleration and penalties of Section 409A: amounts deferred under the DCA for the current taxable year and all preceding taxable years are includable in gross income and are subject to the additional penalty tax equal to 20% of the compensation required to be included in gross income. Interest is also added at the underpayment rate plus 1% from the year in which the amount was first deferred.

The First Prong: What is a DCA Under the New Law

Generally. A DCA under Section 409A may be an individualized arrangement (e.g., an employment agreement) or a more formal and broader plan (e.g., a nonqualified supplemental retirement plan in which all management-class employees participate). What Section 409A is generally looking for is an arrangement that provides for the deferral of the payment of compensation owed to a "service provider" (in which the service provider has a "legally binding" right to the deferred compensation) into a later

year. Excluded from the definition of a DCA is a (i) "qualified" retirement plan (i.e., a tax qualified pension, profit-sharing, Section 401(k) plan, Section 403(b) tax deferred annuity, or a Section 457(b) eligible plan for state, government, or tax exempt employees; or (ii) a bona fide vacation, sick leave, disability pay, or death benefit plan.

Except for these excluded plans and arrangements, any and all compensatory scenarios that defer income into a future year require scrutiny in order to determine if Section 409A is applicable.

According to Notice 2005-1 and the Proposed Regulations, the employee or independent contractor providing the services is referred to as the "service provider". For simplicity sake, we will refer to the service provider as the employee. The entity to whom the service provider is rendering services is referred to as the "service recipient". For simplicity sake, we will refer to the service recipient as the employer.

A Legally Binding Right to Deferred Compensation. As noted above in the confusing general rule of what constitutes a Section 409A deferral, there is such a deferral only if the employee has a legally binding right to compensation that has been deferred into a future year. If the employer may unilaterally reduce or eliminate that right to compensation, there is no legally binding right. Notice 2005-1 notes, however, that if under the facts and circumstances of a particular case, the employer would be unlikely to reduce or eliminate the deferred compensation, the employee would be deemed to have a legally binding right to it. The Proposed Regulations take the legally binding right to compensation a step further by stating that the if the facts and circumstances indicate that the employer's discretion to reduce or eliminate compensation is available only upon occurrence of a condition, the employee is considered to have a legally binding right to the deferred compensation. The Proposed Regulations specifically state that even if the employee's right to the deferred compensation is subject to an SROF, he or she is deemed to have a legally binding right to it and there is a DCA under Section 409A.

Example: Dave is a newly hired professional employee of PC, Inc. In addition to his regular salary and bonus

compensation, PC provides Dave an additional fringe benefit in the form of a nonelective deferred compensation arrangement (contractual differences between elective and nonelective arrangements will be discussed below). However, Dave's right to the deferred compensation is subject to an SROF that he maintain his status as a full time employee of PC for the next 10 years in order to vest the deferred compensation. Even though Dave is an at will employee and could be fired by PC at any time thus losing his deferred compensation, he is deemed to have a legally binding right to it. Therefore, the nonelective deferred compensation arrangement is a DCA under Section 409A. Absent application of the short-term deferral exception noted in the next paragraph, the DCA must be in writing and otherwise comply with the requirements of Section 409A.

A Major Exception to the Rules Just Noted.

The short-term deferral exception is a significant exception to the characterization of an arrangement as a DCA. Under the short-term exception, if deferred compensation is paid out in full within two and one-half months after the year of its vesting, the arrangement is deemed to never have constituted a Section 409A deferral. This would be relevant not only for annual bonuses determined on the basis of productivity for the year, but also with long-term deferrals where the payout occurs shortly after the SROF lapses.

Example: The executives of Hospital (a Section 501(c)(3) employer) participate in a nonqualified deferred compensation arrangement between them and the Hospital. Since the employer is a tax-exempt entity, the arrangement must conform to Section 457 in addition to Section 409A.¹ Because of the amounts of deferred compensation, the arrangement is structured as an

¹ The Section 409A Rules apply to nonqualified deferred compensation plans under Section 457(f) in addition to the requirements already applicable to such plans under Section 457(f).

"ineligible" Section 457(f) plan. Under such a plan, in order to avoid current income taxation under Section 457, the deferred benefits must be continually subject to an SROF. The plan provides that upon the executives obtaining age 62 while still in the full-time employ of Hospital, they will vest the deferred benefits which will be paid in a lump-sum within 60 days of vesting.

Although the actual payments of the vesting deferred compensation may be delayed many years, the arrangement does not constitute a DCA under Section 409A since the complete payout will occur well within two and half months of the end of the vesting year (before the vesting date the deferred compensation had been continually subject to an SROF).

Separation Pay Arrangements. Under the general definition of what constitutes a DCA just noted, post-termination severance pay arrangements would generally constitute a DCA. The Proposed Regulations, however, have excepted certain severance pay arrangements from being ever defined as a DCA.²

There are two exceptions for severance pay arrangements that are of potential interest to the closely-held employer.³ The first of these two is applicable for severance arrangements payable in the event of an involuntarily termination of employment if the severance cannot be greater than two times the lesser of: (i) the employee's annual taxable compensation for the calendar year prior to the year of separation from service, or (ii) the compensation limitation under Code §401(a)(17) for qualified requirement plans (\$220,000 for 2006). All payments under this exception must be made no later than December 31 of the second calendar year following the year of separation of service.⁴

² Proposed Reg. Section 1.409A-1(b)(9).

³ A third exception is for collectively bargained separation pay arrangements. Proposed Reg. Section 1.409A-1(b)(9)(ii).

⁴ Proposed Regulation Section 1.409A-1(b)(9)(iii).

The second exception deals with so-called "window" programs. This is the only exception under the severance pay rules for voluntary, as opposed to involuntary, terminations. The Proposed Regulations require that the availability of the window program continue for only a limited period of time and, in no event, more than for one year. Additionally, window programs have to comply with the dollar limitations just noted in the prior exception. The trouble with window programs is that this exception is difficult to fashion on an individual or small group basis. The Proposed Regulations require that the window program be left open for less than one year for employees who separate from service during that period under specified circumstances (for example, as a short-term early retirement incentive). If the employer establishes a pattern of repeatedly providing for similar separation pay in similar situations for substantially consecutive periods of time, the program would not be considered a window program.

If the severance pay arrangement fails to fit into either of these exceptions, and is not otherwise covered by the short-term deferral exception noted earlier, the severance pay arrangement constitutes a DCA and must comply with the Section 409A Rules. It is relevant, however, that such severance pay arrangements are treated as a separate class of DCA under Section 409A. That is, separation pay arrangements are treated as distinct from account balance DCAs (defined contribution DCAs), nonaccount balance DCAs (defined benefit DCAs), and other Section 409A DCA's (equity-based DCAs discussed in the next section). Generally, all plans in the same class are aggregated and treated as one plan. Thus, the separation pay arrangement that constitutes a DCA may provide a different amount and form of deferred compensation benefit than that payable to the employee on separation from service under other DCA's maintained for his or her benefit by the same employer.

Stock Options as DCAs. Notice 2005-1 and the Proposed Regulations clarify a prior area of confusion under the new law. An option to purchase stock that is a "nonstatutory stock option" may be deemed to be a DCA. More specifically, a nonstatutory stock option is one

other than an incentive (qualified) stock option described in Code Section 422. Therefore, the typical stock option, being nonqualified, will constitute a nonstatutory stock option as defined under the new law.⁵ A nonstatutory stock option will further constitute a DCA subject to Section 409A if the amount required to purchase stock under the option is less than the fair market value of the underlying stock on the date the option is granted. The phrase "fair market value" refers to the true, objective fair market value of the underlying stock, not necessarily what the grantor and grantee of the option deem to be fair market value. Notice 2005-1 had requested "comments on appropriate techniques for valuation of stock subject to options or stock appreciation rights where the value of such stock is not established by and in an established securities market, in order to ensure that such valuation reflects the actual fair market value of the stock". The Proposed Regulations look for a consistent and reasonable valuation method and add certainty in this analysis. Certain safe-harbors (e.g., independent appraisal at time of grant) are available. Certain widely-used valuation formulas, such as book-value formulas, that do not necessarily equate to true fair market value, are problematic.

Even in the case where the nonstatutory stock option is a DCA under the new law, the arrangement (like any DCA) may avoid a plan failure and the resulting tax acceleration and penalty. For example, as would frequently be the case with options involving closely-held stock, specifying an exact exercise date, or providing an exercise period that is not more than 2-1/2 months after the year in which the option vests will avoid Section 409A problems.

The Second Prong: is the DCA Subject to a Substantial Risk of Forfeiture?

Substantial Risk of Forfeiture

Having established that the arrangement is a DCA, the second step in the analysis is to determine if the DCA is subject to an SROF. The Section 409A Rules state that the right of the

⁵ Proposed Regulation Section 1.409A-1(b)(5); Notice 2005-1, Q and A-4(d).

employee to deferred compensation is subject to a substantial risk of forfeiture if the compensation is conditioned on the future performance of substantial services by any individual. This is the same definition of an SROF as is found in Section 83(c)(1) on transfers of property in connection with the performance of services. However, Section 409A authorizes the Treasury Department to issue regulations disregarding an SROF in cases where necessary to carry out the purposes of the Section 409A. Following that lead, Treasury noted in the Proposed Regulations that certain arrangements that could possibly constitute an SROF under the Section 83 regulations (for example, noncompete agreements) would not constitute an SROF for purposes of Section 409A.

Thus, an SROF for Section 409A purposes must be real and substantial. The Proposed Regulations also scrutinize the substantiality of an SROF if the employee owns a significant amount of his or her employer. The criteria in the Notice and Proposed Regulations focus on the employee's effective control and dominion over the employer, thus making any purported SROF less likely to be exercised by the employer. Therefore, in the case of a closely-held DCA that is providing a DCA benefit to a controlling shareholder-employee, it should be presumed that any nominal SROF would be ineffective and proceed with the drafting of the DCA in a manner that would preclude a plan failure during its entire existence.

The Third Prong: at the Time the DCA is Not Subject to a Substantial Risk of Forfeiture is there a Plan Failure?

General Plan Failure Rules

Early Distribution. Plan failures under the new rules can take a variety of forms. The first would result from the possibility of an improper early distribution under the DCA. An improper early distribution possibility is present if the plan could pay any benefits prior to: (1) the date of the employee's separation from service during life; (2) the employee's death; (3) the employee's disability; (4) the time specified in the plan for payout; (5) the time of a change in the ownership or effective control of the employer; or (6) the occurrence of an unforeseen emergency. Note

that only points (1) and (2) are predicated on the employee's termination of employment. Points (3)-(6) are addressed in the Proposed Regulations in a way that presumes DCA payout irrespective of the employee's actual term of employment.

Separation from service requires permanent cessation of employment. Significant post-termination consulting would preclude a separation from service and leaves of absence do not generally constitute separation from service. Thus, payouts that occur on "retirement" defined as mere term of employment may require amendment (the employee could retire as a common-law employee yet continue to render substantial post-retirement consulting services as an independent contractor).

The DCA may also provide for deferred compensation to be paid to an in-service employee at a time and in a manner specified at the time of deferral. The rules under this scenario are flexible despite the statutory statement on specificity. The specified time and fixed schedule of payments need be objectively determinable as to the amount and tax year of payment. For example, a DCA that provides that deferred compensation will be made in three annual payments on December 31 following an initial public offering of the employer would satisfy the requirements that the DCA provide for payments at specified times pursuant to a fixed schedule.

To the extent that an unamended pre-Section 409A DCA allows for a payout irrespective of the employee's separation from service on change in control of the entity, it is likely that the change in control definition will have to be modified by amendment to comply with the rather unique Section 409A definition of change in control.⁶

Similarly, if a disability payout will occur irrespective of separation from service, the required definition under Section 409A will be needed. A disability is defined under Section 409A as a mental or physical impairment qualified for Social Security disability payments, or a disability that is expected to last for more than a year and (1) one that prevents the employee from engaging in substantial gainful activity, or (2) for which the employee is receiving disability income benefits under an

⁶ Section 409A(a)(2)(A)(v).

employer disability plan for at least three months.⁷

An unforeseen emergency is a severe financial hardship to the participating employee resulting from an illness or accident to the participant, the participant's spouse, or a dependent of the participant not compensated or reimbursed through insurance or otherwise. An unforeseen emergency also includes a loss of the participant's property due to casualty or a similar extraordinary and unforeseeable circumstance.⁸

The legislative history notes that the DCA could allow participants different forms of payment (as long as objectively ascertainable) for different permissible distribution events. The DCA could provide, for example, that the employee would receive a lump-sum distribution upon a Section 409A defined disability, but receive an annuity stream upon separation from service.⁹ Thus, a DCA benefit payout on separation from service for any reason must provide the same payout amount at the same time regardless of whether separation from service is due to retirement or disability or change in control. If, however, the parties want to provide a different benefit on disability or change in control, or if the employer wants to provide a DCA payout on disability or change in control irrespective of separation from service, the plan would have to segregate that benefit from the separation from service scenario with the triggering event conforming to the Section 409A definitions of those terms.

Lastly, it was fairly common pre-Section 409A that a deferred compensation agreement would give the employer a unilateral right to change the form of deferred compensation payments. For example, the employer, in its sole discretion, might have had a right to make a discounted lump-sum payment in lieu of monthly payments to be made for 20 years. Such a provision post-Section 409A would violate the requirement that the amount and time of DCA payments be objectively determinable at the time of deferral.

⁷ Section 409A(a)(2)(A)(ii).

⁸ Section 409A(a)(2)(A)(vi).

⁹ House Report 108-755 at 733.

Subsequent deferral. A plan failure also includes an ability to again defer payments due to be made under the terms of the DCA. The plan may permit subsequent elections to delay or change the form of payments if the new election cannot take effect until at least 12 months after it is made. Also, an election to further defer a distribution due to be made after the participant's separation from service, upon a predetermined date or schedule or upon a change in ownership of the employer, must defer the delayed payment for at least an additional five years.¹⁰

Initial deferral election for Elective DCAs. Another major category of plan failure relates to the initial deferral election for elective DCAs (in which the deferral decision is initiated by the employee). Let's first distinguish elective from nonelective DCAs.

There are two broad structural categories of DCAs: elective and nonelective. An elective DCA is one under which the employee opts to receive less salary and/or bonus compensation than he or she would otherwise currently receive and to defer receipt of the reduced amount to a future tax year. The point here is that the initiative behind the deferral comes from the employee. Because the employee is initiating the deferral of compensation that he or she would otherwise shortly earn and receive, it would be inappropriate to impose an SROF on the deferred compensation. Therefore, an elective deferral would normally be fully vested from its inception.

Nonelective deferred compensation is a different scenario. It is not unusual for employers to provide a deferred compensation benefit as a fringe benefit to key employees. It does not result in a reduction in their salary and bonus compensation otherwise payable. Rather, the nonelective arrangement is typically in the nature of an add-on benefit. This is the so-called "velvet handcuff" mechanism for retaining key employees, and usually incorporates within the arrangement an SROF requiring a number of years of service before the benefits become nonforfeitable.

Elective deferrals must specify the time and form of payment on deferral. Additionally, Section 409A requires that a participant's elective deferral

¹⁰ Section 409A(a)(4)(C).

is effective only if it is made before the tax year in which the deferred compensation will be earned (e.g., a salary reduction agreement entered into on or before December 31, 2006, to defer 10% of compensation that would otherwise be earned and payable in the 2007 calendar year). If the electively deferred compensation is based on performance criteria or services performed over a period of at least 12 months (e.g., bonus compensation based on a fiscal year net profit increase), the election must be made no later than six months before the end of the measurement period. With regard to a new participant (for example, a new officer hired mid-year), the election must be made within 30 days after the date the new participant becomes eligible to participate in the DCA and initiate deferrals for the remainder of that year. A deferral election as to future compensation that remains in place unless the employee changes the election (an evergreen election) is generally permissible.

A nonelective DCA does not have to contend with the specific timing rules just noted, but the underlying contract must be entered into before the deferred compensation is earned and the amounts and timing of the deferred compensation payout must be objectively determinable.

Funding arrangements. Long before the advent of Section 409A, formally funding a nonqualified deferred compensation obligation accelerated the taxable event to the participating employee. To the extent that the participant had a vested, nonforfeitable interest in any trusteed or escrowed money (a "secular" trust) to be used to satisfy DCA payments, taxation on the deferred compensation was, and is, accelerated under Section 83.

An important and frequently used device to somewhat enhance the likelihood that deferred compensation will be paid without accelerating the taxable event is through "informal" funding of the obligation in a rabbi trust. In a rabbi trust, the employer contributes money to a trust to satisfy the deferred compensation obligations. Yet that wealth remains subject to the employer's general and secured creditors in the event of legal insolvency or bankruptcy. Because of this contingency in a rabbi trust, the IRS has long acknowledged that employee taxation is not accelerated.¹¹

The new law does not change this result except in the rarest situations. Under the Section 409A Rules, employee taxation through the use of a rabbi trust is accelerated only if the trust is an off shore trust (thus providing a practical impediment to employer creditors reaching the trust assets) or if it is a "springing" arrangement under which a pre-existing rabbi trust would contractually flip to secular trust status (or would be first funded) upon a negative change in the employer's financial health short of legal insolvency or bankruptcy.¹²

CONCLUSION

It is incumbent upon the closely-held employer to scrutinize any arrangement (regardless of how labeled) for deferrals of income beyond the year in which earned by the benefited employee. To the extent that such deferrals are not specifically excepted from the Section 409A Rules (short-term deferrals, welfare benefit plans, certain involuntary severance pay arrangements), it is likely that such arrangements are subject to Section 409A. Hopefully, few amendments will be required before 2008 to address the Section 409A issues in the traditional nonqualified deferred compensation arrangement. The adviser must additionally explore for such deferrals in other contractual arrangements to assure that deferred bonuses, rights to purchase equity in the employer, severance pay and other deferrals are contractually accounted for under Section 409A.

¹¹ Rev. Proc. 92-64, 1992-2 C.B. 422.

¹² Section 409A(b).