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Code § 409A Nonqualified Deferred Compensation Rules

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Table of Contents
[Manual TOC]

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Introduction

In April 2007, the Internal Revenue Service ("IRS") issued Final Regulations under Code § 409A, which imposes new rules on nonqualified deferred compensation arrangements.[1] All arrangements that are subject to the new rules had to be in full compliance with the Final Regulations, both in form and operation, no later than December 31, 2008. This outline discusses the types of arrangements that are potentially subject to Internal Revenue Code ("Code") § 409A and the requirements that must be satisfied in order to be in full compliance with the Final Regulations, including special transition rules.

A. Which Plans are Subject to § 409A

Restrictions on Deferred Compensation. The American Jobs Creation Act of 2004, H.R. 4520, P.L. 108-357, enacted Oct. 22, 2004 ("AJCA"), imposes significant restrictions on the ability to defer nonqualified deferred compensation.[2]

Code § 409A, enacted by AJCA, provides that "nonqualified deferred compensation plans" will be subject to immediate taxation, 20% additional tax and premium interest unless they comply with various requirements relating to elections and distributions.[3]

Specifically, if during a taxable year a nonqualified deferred compensation plan fails to meet the requirements of Code § 409A(a)(2), (3) and (4) relating to advance elections, limitations on distributions, and barring of accelerations, all compensation deferred under the plan for the taxable year and all preceding taxable years will be includible in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.[4] There will also be interest on the underpayment at the underpayment rate plus one percent from the time of original deferral

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1 Proposed Treasury Regulations § 1.409A were published in 70 Fed. Reg. 57930 (Oct. 4, 2005) ("Proposed Regulations"). Final Treasury Regulations § 1.409A were originally issued April 10, 2007 at http://www.ustreas.gov/press/releases/reports/td9321.pdf and published in 72 Fed. Reg. 19234 (April 17, 2007) ("Final Regulations"), and are generally applicable for taxable years beginning in 2008, with the transition relief and amendment of plans deferred through December 31, 2008 by Notice 2007-86, 2007-46 I.R.B. 990 (but with good faith compliance under Notice 2005-1 or the Final Regulations in the interim). Notice 2005-1, 2005-2 I.R.B. 274, Q&A 2, which provided initial guidance and transition rules, become obsolete once the 409A regulations become effective.

2 These rules are intended to prevent abuses by executives regarding deferred compensation and severance, as publicized in the Worldcom and Enron bankruptcies, such as amendments to accelerate receiving benefits just before a company would go bankrupt, and serve generally to restrict access to deferred compensation until it is due and payable.

3 Code § 409A(a) added by § 885(a) of AJCA.

4 Code § 409A(a)(1)(A)(i).

or vesting, as well as an additional tax equal to 20% of the compensation included in income, as described below.

Definition of NQDC Plan and Exception for Certain Qualified and Welfare Plans. A nonqualified deferred compensation plan is defined as a plan that provides for the "deferral of compensation," other than a qualified employer plan (such as a qualified pension or profit sharing plan, a SEP or SIMPLE plan, a tax sheltered annuity, an eligible 457(b) plan and certain other similar plans),[5] and other than the following welfare benefits: bona fide vacation leave, sick leave, compensatory time and certain plans that provide disability pay or death benefits.[6] "Plan" includes any agreement, method, program or arrangement, including those just for one person, and regardless of whether or not it is a plan under ERISA.[7] Nontaxable medical reimbursement arrangements (including health savings accounts) are exempt from § 409A.[8]

Nonqualified deferred compensation plans that could be subject to § 409A rules would include, for example, plans where the executive can defer salary or bonus, long-term bonus arrangements, supplemental executive retirement programs, certain severance arrangements, as well as other arrangements discussed below.

Exception for 457(b) Eligible Plans but Not for 457(f) Ineligible Plans. As discussed above, Code § 457(b) "eligible" plans (for tax-exempt employers) are exempt from § 409A just like qualified plans.[9] However, § 457(f) "ineligible" plans are subject to § 409A (to avoid 20% additional tax) separately and in addition to any requirements applicable to any requirements under § 457(f) (i.e., taxation on vesting), as stated in regulations, because they are nonqualified deferred compensation plans.[10] Nevertheless, the regulations provide that 457(f) plan deferrals by reason of being immediately included in income of the employee on vesting, will be considered a short-term deferral for purposes of §

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5 Code § 409A(d)(1); Treas. Reg. § 1.409A-1(a)(2) [pg. 195 (page references are to Final Regulations issued April 10, 2007 at http://www.ustreas.gov/press/releases/reports/td9321.pdf)]

6 Code § 409A(d)(1); Treas. Reg. § 1.409A-1(a)(5) [pg. 200], as amended in 72 Fed. Reg. 41620 (July 31, 2007). Disability pay and death benefits are defined in Treas.Reg. § 31.3121(v)(2)–1(b)(4)(iv)(C). That regulation provides that payments made under a nonqualified deferred compensation plan in the event of death are "death benefits," but only to the extent the total benefits payable under the plan exceed the lifetime benefits payable under the plan. Similarly, payments made under a nonqualified deferred compensation plan in the event of disability are "disability pay," but only to the extent the disability benefits payable under the plan exceed the lifetime benefits payable under the plan.

Life insurance payments on death should also be exempt from § 409A as a death benefit.

7 Treas. Reg. § 1.409A-1(c)(1) [pg. 250].

8 Treas. Reg. § 1.409A-1(a)(5) [pg. 200]. These would have to be nontaxable under Code §§ 105, 106, 220 and 223. See also Treas. Reg. § 1.409A-3(i)(1)(iv)(B) [pg. 347] that medical reimbursements (even those not meeting this exception) can meet the exception for in-service expense reimbursements even if there is a multiyear maximum where expenses eligible in one year may affect expenses eligible in another year.

There is no blanket exclusion for split-dollar life insurance arrangements that defer compensation. Preamble to Proposed Regulations, 70 Fed. Reg. at 57941.

9 Code § 409A(d)(1); Treas. Reg. § 1.409A-1(a)(2) [pg. 195].

10 Treas. Reg. § 1.409A-1(a)(4) [pg. 199].

409A, and therefore is not subject to any additional 409A requirements.[11] The Preamble to the Final Regulations notes, however, that the right to earnings on amounts that have previously been included under section 457(f) will be deferred compensation for purposes of section 409A unless the right to the earnings independently satisfies the requirements for an exclusion.[12]

. *Service Provider*. For simplicity, the terms employee and employer, rather than service provider and service recipient, are used herein. However, the rules of § 409A apply to service providers even if they are not employees. The term service provider includes an individual, corporation, partnership, personal service corporation, etc.[13] An independent contractor could be considered a service provider. However, there is an exception under the 409A regulations for independent contracts who provide significant services to two or more unrelated service recipients (with "significant" meaning that no more than 70% of the independent contractor is received from any one client), that they are not treated as service provides under § 409A.[14]

Savings Clauses Disregarded. For purposes of determining the terms of a plan, general provisions of a plan that purport to nullify noncompliant plan terms (savings clauses) are disregarded.[15]

Exception for Foreign Arrangements. There are exceptions for foreign arrangements, that they will not be deferrals of compensation if (i) the amounts would not have been included in federal income tax at the time of the legally binding right (or vesting) and the employee was a nonresident alien at the time, (ii) the amounts would have been excluded under treaty, or (iii) a U.S. citizen was working

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11 Treas. Reg. § 1.409A-1(a)(4) [pg. 200]. As explained in the Preamble to Final Regulations: "payment generally refers to an actual or constructive payment … However, … for purposes of the short-term deferral rule, an amount is treated as paid when it is included in income under section 457(f) whether or not an actual or constructive payment occurs. Accordingly, where the income inclusion under section 457(f) stems from the lapse of a substantial risk of forfeiture … the amount included in income will be considered a short-term deferral for purposes of section 409A. Preamble to Final Regulations, 72 Fed. Reg. at 19234 [pg. 5].

In Notice 2007-62, 2007-32 IRB 331, the IRS announced plans to publish guidance which would apply the Code § 409A definition of substantial risk of forfeiture, as set forth in Treas. Reg. §1.409A-1(d) [pg. 259], to 457(f) plans. The § 409A definition of substantial risk of forfeiture is narrower than the § 83 definition, as noted below. For example: (i) a condition related to the purpose of the compensation must relate to the employee's performance for the employer or the employer's business activities or organizational goals (e.g., attainment of a prescribed level of earnings, or equity value or completion of IPO); and (ii) a condition based on refraining from performing services (such as a covenant not to compete) does not give rise to a § 409A substantial risk of forfeiture. Treas. Reg. § 1.409A-1(d)(1) [pg. 259]. (Notice 2007–62 also discusses the definition of a bona fide severance pay plan under § 457(e)(11).)

12 Preamble to Final Regulations, 72 Fed. Reg. at 19234 [pg. 5].

13 Treas. Reg. § 1.409A-1(f)(1) [pg. 265].

The term service provider generally includes a former service provider. Treas. Reg. 1.409A-1(f)(1) [pg. 265.]

14 Treas. Reg. § 1.409A-1(f)(2) [pg. 265].

15 Treas. Reg § 1.409A-1(c)(1) [pg. 250] and Preamble to Final Regulations, 72 Fed. Reg. at 19250 [pg. 74]. IRS officials have indicated that it may nevertheless be beneficial to have a provision in the plan that the plan is intended to comply with, and to be operated in accordance with Section 409A and should be construed and interpreted in accordance with Section 409A. This will not help, though, to override unambiguous terms in the plan that violate § 409A.

abroad for part of the year and at the time of the legally binding right (or vesting) and the amounts would have been exempt under Code § 911.[16]

Aggregation and Types of Plans. Section 409A is applied on an individual plan basis as if separate plans are maintained by each participant.[17] However, multiple plans of a "single type" for a single participant are aggregated, with "single type" defined as

(i) elective deferrals under account balance plans (as defined in Treas. Reg. § 31.3121(v)(2)-1(c)(2)(ii)(A)) (other than plans listed in (D)-(H) below) (Treas. Reg. § 1.409A-1(c)(2)(i)(A) [pg. 250]);

(ii) employer contributions to individual account plans (i.e., deferrals that are not elective by the employee, e.g., profit-sharing contributions or matching contributions) (§ 1.409A-1(c)(2)(i)(B));

(iii) deferrals under non-account balance plans (other than the plans listed in (D)-(H) below) (§ 1.409A-1(c)(2)(i)(C));

(iv) deferrals under separation pay plans (payable on involuntary separation or under a window) (§ 1.409A-1(c)(2)(i)(D));

(v) rights to in-kind benefits or reimbursement of expenses (e.g., membership fees, aircraft usage reimbursement, etc.) to the extent they do not constitute a substantial portion of overall compensation (§ 1.409A-1(c)(2)(i)(E));

(vi) split-dollar life insurance arrangements (§ 1.409A-1(c)(2)(i)(F));

(vii) deferrals of compensation that would be treated as modified foreign earned income (§ 1.409A-1(c)(2)(i)(G));

(viii) deferrals of stock rights (§ 1.409A-1(c)(2)(i)(H)); or

(ix) all other deferrals of compensation not described above (§ 1.409A-1(c)(2)(i)(I));.[18]

Note that a plan that is exempt from § 409A would presumably not be aggregated with a § 409A plan.

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16 Treas. Reg. § 1.409A-1(b)(8) [pg. 237]. See similar exemption from definition of nonqualified deferred compensation plan under Treas. Reg. § 1.409A-1(a)(3) [pg. 196].

17 Treas. Reg. § 1.409A-1(c)(1) [pg. 250].

18 Under this aggregation rule, failure of one plan to comply with § 409A could cause taxation and penalties for all of the employee's aggregated plans.

See ABA Joint Committee on Employee Benefits ("ABA JCEB") Q&As for IRS (2008) Q&A 32 that multiple agreements between the same parties with respect to different projects would be aggregated. See also, Q&A 37 that if the employee receives extra years of credit in a defined benefit SERP if terminated without cause, etc., that additional amount is considered a deferral under a separate plan and not a deferral under the nonaccount balance plans.

Deferral of Compensation - Legally Binding Right. "Deferral of compensation" means that the service provider has a legally binding right during a taxable year to compensation that pursuant to the terms of the plan is or may be payable in a later year.[19]

The final regulations clarify that a legally binding right to receive a nontaxable benefit that would not be included in income when received in any event, it is not a deferral of compensation for purposes of section 409A.[20]

Payroll compensation that is payable in the next taxable year pursuant to the employer's customary timing arrangement (i.e., payable in the ordinary course) is not a deferral of compensation under 409A.[21] A legally binding right to compensation may exist even where the right is subject to substantial risk of forfeiture.[22] However, if still subject to a substantial risk of forfeiture, i.e., not yet vested until a later period, the tax for violation of § 409A would not yet apply, and the 2 ½-month short-term deferral exception would not yet start to run until the end of the year in which the amount vested, as discussed below.

Not Discretionary Plans. An employee does not have a legally binding right to compensation to the extent that it may be unilaterally reduced or eliminated by the employer after the services have been performed.[23] Thus, a plan that can be terminated by the employer is discretionary and is not subject to § 409A.

2 ½-Month Short-Term Deferral Exception. IRS guidance provides that there is no deferral of compensation (for, e.g., annual bonuses or other annual compensation amounts) under a plan with respect to any payment that is not a deferred payment,[24] provided that the employee actually or constructively receives the payment no later than the 15th day of the third month following the end of the

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19 Treas. Reg. § 1.409A-1(b)(1) [pg. 201].

20 Treas. Reg. §1.409A-1(b)(1) [pg. 201]. There is an exception to this rule if the nontaxable right is received in exchange for a taxable amount (other than under a cafeteria plan). Id.

Also, the plan aggregation rules will not result in taxation of other benefit plans merely because the terms of such nontaxable benefit arrangements would not comply with section 409A if the arrangement were covered by section 409A. Preamble to Final 409A Regulations pg. 67.

21 Treas. Reg. §1.409A-1(b)(3) [pg. 203].

22 Preamble to Proposed Regulations, 70 Fed. Reg. at 57932, and Preamble to Final Regulations, 72 Fed. Reg. at 19236. Thus, an employee promised a bonus in year one of a fixed percentage of employer profits to be paid in year three if still employed, has a legally binding right to the payment even though not yet vested. 70 Fed. Reg. at 57932.

23 Treas. Reg. § 1.409A-1(b)(1) [pg. 201]. If however, the discretion to reduce or eliminate the compensation is available only on a condition, or if the negative discretion lacks substantial significance, the employee will have a legally binding right. Id. If the employee has control over the employer with the negative discretion, the discretion will not have substantive significance and the employee will have a legally binding right. Id.

24 Payment is a "deferred payment" if it is made pursuant to a provision of a plan that provides for the payment to be made in any event after the 2 ½ month period, e.g., on termination of service, change in control, or specific event or time or scheduled event, etc. Treas. Reg. § 1.409A-1(b)(4)(i)(D) [pg. 204], as amended in 72 Fed. Reg. 41620 (July 31, 2007). (The requirement that the plan require payment by the 2 ½ month period is similar to the requirement of Notice 2005-1 Q&A 4(c) but contrary to the Proposed Regulations.)

taxable year (of the employer or the employee, whichever is later) in which the right to the payment is no longer subject to a substantial risk of forfeiture (or if the amount was never subject to forfeiture, the taxable year when there is a legally binding right).[25] For example, an employer with a calendar taxable year who on November 1, 2008 awards a bonus (where the employee has a legally binding right to it and it is substantially vested), will not be considered deferring compensation if it is paid to the employee by March 15, 2009.[26] The short-term deferral exception is not met if the payment need not be made within the 2 ½ month period, even if it in fact is paid within 2 ½ months. An IRS official has indicated that a plan should not merely state that the payment is payable as soon as practicable, but should under Treas. Reg. § 1.409A-(1)(b)(4) specifically specify the payment date or that it will be within the short term deferral period. If any payment may occur later than the 2½ month period, the arrangement is not a short term deferral.[27] There is an exception for a payment that would otherwise qualify as a short-term deferral but is delayed due to unforeseen events that make it administratively impracticable to pay on time or timely payment would jeopardize the ability of the employer to continue as a going concern.[28]

Note that deferral of compensation is measured from the vesting date, so that a bonus arrangement payable over a period of years that requires the employee to be employed on the payment date (or in the taxable year ending within 2 ½ months of payment) is not a deferral of compensation.

See below regarding application to severance arrangements.

School Teachers' Compensation. An arrangement where an employee receives recurring part-year compensation, such as school teachers who teach 10 months and receiving payment over 12 months, will be exempt from § 409A under IRS Notice 2008-62 as long as (i) the arrangement does not defer payment beyond the 13th month following the beginning of the service period, and (ii) the deferral from one taxable year to the next does not exceed the § 402(g) limit ($16,500 in 2010).[29]

Substantial Risk of Forfeiture. Compensation is subject to a substantial risk of forfeiture (for purposes of the 2 ½-month rule[30] or for taxation under § 409A) if it is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a

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25 Treas. Reg. § 1.409A-1(b)(4)(i) [pg. 203]. See also H.R. Conf. Rep. No. 108-755, at 706 (2004) ("Conference Report"). Such short-term deferral arrangements are sometimes referred to as vest and pay plans.

Note that the employee's taxable year is generally the calendar year, so a plan could state 2 ½ months after the calendar year (because the later of the end of the employer taxable year or the end of the employee calendar year would encompass the end of the calendar year).

26 Treas. Reg. § 1.409A-1(b)(4)(iii), Examples [pg. 207].

27 Treas. Reg § 1.409A-1(b)(4)(i)(D) [pg. 204].

28 Treas. Reg. § 1.409A-1(b)(4)(ii) [pg. 205].

29 Notice 2008-62 gives an example of a school teacher who works from August 1, 2008 to May 1, 2009 and is paid over 12 months. The arrangement would not provide for deferred compensation for § 409A (as well as for § 457(f)) if the teacher earns up to $186,000 a year. Since $93,000 is earned in 2008 and $93,000 is earned in 2009, under the 12 month schedule the employee receives $77,500 in 2008 and $108,500 in 2010. The amount earned in 2008 and paid in 2009 is $93,000 - $77,500 or $15,500, which does not exceed the 402(g) dollar limit. (The notice is describing anticipated changes to the 409A regulations, but may be relied upon immediately.)

30 Short-term deferral would run from when amount is vested.

purpose of the compensation, and the possibility of forfeiture is substantial.[31] This definition of substantial risk of forfeiture for purposes of § 409A is somewhat narrower than the definition under § 83. For example, a condition related to the purpose of the compensation must relate to the employee's performance for the employer or the employer's business activities or organizational goals (e.g., attainment of a prescribed level of earnings, or equity value or completion of an IPO).[32] In addition, for § 409A purposes an amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon refraining from performance of services (i.e., noncompetes), in contrast to § 83.[33] Risk of forfeiture provisions may generally not be added after the beginning of a service period, and may also not be extended.[34]

Section 457A – Taxation of Deferred Compensation of Nonqualified Entities. The Tax Extenders and Alternative Minimum Tax Relief Act of 2008[35] adding Code § 457A (originally aimed at managers of offshore hedge funds but applicable to all industries as drafted), generally eliminates the ability of taxpayers to defer compensation for services performed after December 31, 2008 for certain offshore entities, referred to as "nonqualified entities." Under § 457A, deferred compensation under a nonqualified entity's plan is included in gross income to the extent such compensation is no longer subject to a substantial risk of forfeiture. "Nonqualified entities" include (i) any foreign corporation not subject to U.S. taxation, and (ii) any partnership (domestic or foreign) unless substantially all of the partnership's income is allocated to persons other than tax-exempt organizations or foreign persons not subject to a comprehensive foreign income tax.[36] Notice 2009-8 provides interim guidance regarding Section 457A.[37]

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31 Treas. Reg. § 1.409A-1(d)(1) [pg. 258].

32 Id.

33 Treas. Reg. § 1.409A-1(d)(1) [pg. 259].

34 Id.

35 Tax Extenders and Alternative Minimum Tax Relief Act of 2008 § 801, enacted Oct. 3, 2008 together with the $700 billion financial bailout law (the Emergency Economic Stabilization Act of 2008)

36 Under this law investment managers will generally no longer be permitted to defer fees from their offshore funds (and, accordingly, back to back deferral arrangements can no longer be implemented), but should not affect "carried interest" arrangements structured as a partnership interest and certain properly structured hedge fund "side pocket" investments.

37 Nonqualified entity is defined in the notice as: (i) any foreign corporation unless at least 80% of its income is effectively connected to a U.S. trade or business, as defined in Q&A 9 of the notice, or subject to a comprehensive foreign income tax (which generally includes a foreign corporation benefiting from a comprehensive income tax treaty, as defined in Q&A 10, or a foreign corporation that is in a foreign country that has a comprehensive income tax); or (ii) a partnership unless at least 80% of its gross income is allocated to persons other than tax exempt or foreign persons with income not subject to a comprehensive foreign income tax. Notice 2009-8, Q&As 6-11.

Nonqualified deferred compensation has the meaning under §409A, but also includes SARs. Q&A 2. Substantial risk of forfeiture under §457A means rights that are conditioned on the future performance of substantial services. Q&A 3.

There is a short-term deferral exception from §457 if the compensation is paid not later than 12 months after the calendar year in which the compensation vests. Q&A 4.

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B. Section 409A Election, Distribution and Other Restrictions.

Initial Election - Prior to Year Services Performed or Within 30 Days of Becoming Eligible. With respect to deferred compensation subject to § 409A, initial elections as to time and form of payment must be made prior to the taxable year in which the services are to be performed or at such other time provided in regulations.[38] An employee may elect to defer compensation if such election to defer is made not later than the close of the employee's taxable year that precedes the year in which services are performed.[39] The time and form of distributions must be specified at the time of initial deferral.[40] Initial elections for new participants may be made within 30 days after becoming eligible to participate with respect to services to be performed subsequent to the election.[41] Employer elections must also comply with these rules.

For excess benefit plans an employee is treated as initially eligible to participate as of the first day of the employee's taxable year immediately following the first year the employees accrue a benefit under the plan.[42]

With regard to severance pay that is subject to arm's length negotiations at the time of termination of employment, an initial deferral election can be made at any time up to the time the employee obtains a legally binding right to the payment.[43]

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Notice 2009-8 also contains various transition rules. Q&As 22 & 23.

38 Code § 409A(a)(4)(B)(i); Treas. Reg. § 1.409A-2(a)(1) & (2) [pg. 296-298]. The Conference Report indicates that it is not intended that these provisions override the constructive receipt doctrine, and constructive receipt rules continue to apply.

39 Treas. Reg. § 1.409A-2(a)(3) [pg. 299]. See also, Treas. Reg. § 1.409A-2(a)(6) [pg. 300] regarding initial deferral election where the employer has a taxable year that is not the same as the taxable year of the employee.

40 Treas. Reg. § 1.409A-2(a)(1) [pg. 296]. An election as to medium of payment (e.g., cash or property) is not subject to these restrictions. Id. An election is not considered made until the election becomes irrevocable. Treas. Reg. § 1.409A-2(a)(1) [pg. 296]. In certain situations the employer may accelerate time of payment, as discussed below. Id. Elections that carry over to future years' compensation would have to become irrevocable by December 31 with respect to the next year.

41 Code § 409A(a)(4)(B)(ii); Treas. Reg. § 1.409A-2(a)(7) [pg. 301]. Note that because the 30 day rule applies only to services performed after the election, this exception cannot be used in a SERP which provides for prior benefits.

42 Treas. Reg. § 1.409A-2(a)(7)(iii) [pg. 302]. Excess benefit plan is defined to only include plans that provide deferred compensation for the excess of the benefit that would be provided under the qualified plan in absence of the Code limits. Id.

For payments that would otherwise qualify for the 2 ½-month short-term deferral exception, the date the substantial risk of forfeiture lapses is treated as the original time of payment, and therefore an election to defer such amount is treated as a subsequent election, meaning the employee must make the election 12 months before the right to payment vests and cannot defer for less than 5 years. Treas. Reg. § 1.409A-2(a)(4) [pg. 299].

13-Month Rule. Regarding forfeitable compensation elections, where the grant of deferred compensation is subject to a forfeiture condition requiring continued performance for 12 months or more, the initial deferral election must be made within 30 days after the employee obtains the legally binding right to the payment, provided the election is at least 12 months in advance of the end of the service period.[44] Because the election must be made within 30 days, this rule will often require that there be no vesting at all within the first 13 months. Note that the above regulations provide that accelerated vesting for death, disability or change in control will not cause it to violate the 13-month rule.

Elections for Recurring Part Year Compensation. For employees receiving recurring part-year compensation (such as school teachers), an election to defer can be made before the services for which the compensation is paid begins.[45]

Performance-Based Compensation Elections Six Months Prior to End of Period. Elections for performance-based compensation, where the performance period is at least 12 months, may be made no later than six months before the end of the performance period.[46] For example, for a calendar year performance-based bonus plan, elections to defer bonuses can be made by June 30 for bonuses payable in the next year. The Final Regulations require that the employee provided services continuously from the beginning of the performance period, or from when the performance criteria were established, through the date the election to defer is made.[47]

Performance-based compensation under § 409A is compensation the payment of which is contingent on satisfaction of pre-established performance criteria.[48] As stated in the legislative history and Preamble to the Proposed Regulations, performance-based compensation under § 409A is intended to meet some, but not all, of the requirements of Code § 162(m).[49] It need not be approved by a committee of outside directors or by shareholders.[50] However, it must be contingent on satisfaction of pre-established performance goals set within 90 days after the beginning of the performance period, and the

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43 Treas. Reg. § 1.409A-2(a)(ii) [pg. 308].

44 Treas. Reg. § 1.409A-2(a)(5) [pg. 299].

45 Treas. Reg. § 1.409A-2(a)(14) [pg. 312]. See further discussion above regarding interim exemption from § 409A under Notice 2008-62.

46 Code § 409A(a)(4)(B)(iii); Treas. Reg. § 1.409A-2(a)(8) [pg. 303].

47 Id. In no event may the election be made after such compensation has become both substantially certain to be paid and readily ascertainable. Id. See Treas. Reg. § 1.409A-1(e)(1) [pg. 262], which reiterates the requirement that the performance period must be at least 12 months. Note that this 12 month rule is apparently the only requirement that is not required for qualified performance compensation for purposes of Code § 162(m).

48 Treas. Reg. § 1.409A-1(e)(1) [pg. 262]. It does not include any amount that would be paid regardless of performance. Id.

49 H.R. Conf. Rep. No. 108-755, at 732 (2004); Preamble to Proposed 409A Regulations, 70 Fed. Reg. 57930, 57943 (Oct. 4, 2005).

50 Treas. Reg. § 1.409A-1(e)(1) [pg. 262]. This is in contrast to a 162(m) plan which must be established by committee of outside directors, must have shareholder approval of material terms etc., and must have reapproval every 5 years. Treas. Reg. § 1.162-27(e)(3) & (4).

outcome must be substantially uncertain.[51] Under the 409A regulations performance-based compensation may include payments based on subjective performance criteria, provided the subjective criteria are bona fide and relate to the performance of the employee or group that includes the employee.[52] The 409A regulations do not specifically provide for negative discretion after the 90 day period, as do the 162(m) regulations,[53] but it would appear that since the 409A definition is meant to be more expansive than 162(m), and also allows for subjective criteria, negative discretion should be allowed and still be considered performance-based compensation. Compensation committee certification is not required under § 409A.[54] The regulations provide that compensation will be performance-based compensation even though it is also payable upon death, disability or change in control (similar to the 162(m) regulations).[55] The performance-based compensation may be based on an increase in value of the employer or an increase in the price of the employer's stock (e.g., options or stock appreciation rights ("SARs") to the extent they are subject to § 409A), but may not be equal to the total value of shares (e.g., restricted stock units (RSUs)).[56]

Subsequent Elections - 12-Month Delay and Five-Year Deferral. Subsequent elections to delay a payment or change the form of payment are only valid if the plan requires that: (i) the election may not take effect until at least 12 months after the date on which the election is made; (ii) in the case of payment that is either upon separation from service, at a specified time, pursuant to a fixed schedule, or upon a change in control (but not upon disability, death or unforeseeable emergency), the election must delay payment at least five years beyond the originally scheduled date; or (iii) in the case of payment at a

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[51] Treas. Reg. § 1.409A-1(e)(1) [pg. 262]. This is similar to the § 162(m) plan which must be contingent on satisfaction of pre-established performance goals set within the lesser of 90 days after the beginning of or 25% of the performance period. Treas. Reg. § 1.162-27(e)(2)(i).

The regulations provide for an allocation where some of compensation is performance based and some is not. Treas. Reg. § 1.409A-1(e)(1) [pg. 263].

[52] Treas. Reg. § 1.409A-1(e)(2) [pg. 263-264]. For purposes of § 162(m), however, subjective perfomance criteria is not permitted.

[53] Treas. Reg. § 1.162-27(e)(2)(ii) & (iii).

[54] This is in contrast to Treas. Reg. § 1.162-27(e)(5), where compensation committee certification of meeting goals is required.

[55] Treas. Reg. § 1.409A-1(e)(1) [pg. 263]. However, as noted by one Treasury official, by analogy, the limitation of Revenue Ruling 2008-13 regarding Code § 162(m) should also apply to § 409A, and if the compensation is payable even without meeting the performance targets upon termination without cause, quitting for good reason or, voluntary retirement, then the amount should not be performance-based compensation even if the targets are in fact met.

[56] Treas. Reg. § 1.409A-1(e)(3) [pg. 264] (contrary to Notice 2005-1, Q&A 22).

This is in contrast to Treas. Reg. § 1.162-27(e)(2)(vi), where options or SARs are deemed to satisfy pre-established-objective-performance-goal requirement only if granted by the compensation committee, plan gives maximum number of shares with respect to which options or rights may be granted during a specified period to any employee, the amount of compensation the employee could receive is based solely on an increase in the value of stock after the date of grant, and the plan must be approved by the shareholders.

specified time or pursuant to a fixed schedule, the election must be made at least 12 months before the first scheduled payment.[57] A subsequent deferral election is not considered made until irrevocable.[58]

A change in a beneficiary will not be treated as a change in the time and form of payment, if the change in the time of payment stems solely from the different life expectancy of the new beneficiary, such as in the case of a joint and survivor annuity.[59]

Designation of Separate Payments for Purposes of Subsequent Changes in Time or Form of Payment and Stacking. Regarding the definition of "payment," regulations provide that generally each separately identified amount to which an employee is entitled under a plan on a determinable date is a separate payment.[60] This treatment of a series of payments as separately identified amounts will be beneficial for purposes of subsequent changes in time or form of payment, for purposes of exempting certain payments as short-term deferrals, and for assisting in stacking of exemptions (e.g., for the 2 years / 2 times pay exception). The entitlement to a series of installment payments under an arrangement is generally treated as a single payment. However, a plan may specify that a series of installment payments is to be treated as a series of separate payments.[61]

Multiple Payment Events. A plan may provide for a different form of payment depending upon the payment event.[62] A plan can provide multiple payment events, i.e., that the payment will be made on the earlier or later of multiple permissible payment events.[63] Similarly, a plan may provide that an intervening event that is a permissible payment event may override an existing payment schedule already in payment status.[64]

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57 Code § 409A(a)(4)(C); Treas. Reg. § 1.409A-2(b)(1) [pg. 313].

58 Treas. Reg. § 1.409A-2(b)(1) [pg. 313]. Therefore, a subsequent deferral election can be changed until the last permissible date for making a subsequent deferral election. Id.

59 Treas. Reg. § 1.409A-2(b)(3) [pg 319-320].

60 Treas. Reg. § 1.409A-2(b)(2)(i) [pg. 314]. This could occur where the right arises under a separate plan arrangement or where the arrangement identifies the amount as a separate payment. An amount is separately identified if the amount may be objectively deferred under a nondiscretionary formula. Id.

61 Treas. Reg. § 1.409A-2(b)(2)(iii) [pg. 318]. If an amount is separately identified as a payment, the amount will not be aggregated with other amounts for purposes of the rules relating to subsequent changes in the time and form of payment and the anti-acceleration rule.

62 Treas. Reg. § 1.409A-2(b)(6) [pg. 321]; Treas. Reg. § 1.409A-3(j)(1) [pg. 369]. See also, Treas. Reg. § 1.409A-3(b) [pg. 332].

63 Treas. Reg. § 1.409A-2(b)(6) [pg. 321].

64 Treas. Reg. § 1.409A-2(b)(6) [pg. 321]. The addition or deletion of the payment event or date will be subject to the rules governing changes in the time and form of payment and anti-acceleration rules, and therefore no fixed time of payment could be added or deleted that did not defer the payment at least five years from the date the fixed time was added. Treas. Reg. § 1.409A-2(b)(6) [pg. 321]; Treas. Reg. § 1.409A-3(j)(1) [pg. 369].

Different Life Annuities Treated as Single Form of Payment. A life annuity is generally viewed as a single form of payment.[65] Thus, elections among different annuity forms with or without survivor benefits can be made at any time before the annuity starting date.[66]

Permissible Distribution Events. Under Code § 409A(a)(2), the plan must provide that distributions from deferred compensation plans may be made only upon one of the following events: (i) specified date or fixed schedule, (ii) separation from service, (iii) disability, (iv) death, (v) change in control or (vi) unforeseeable emergency.

Permissible Distribution Event – (i) Specified Date or Fixed Schedule. Under Code § 409A(b), distributions may be made at a specified time or pursuant to a fixed schedule specified in the plan and determinable at the time of the initial deferral election.[67] Plans can specify simply the year or years in which the payments are scheduled to be made, or an objectively determinable period.[68]

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[65] Treas. Reg. § 1.409A-2(b)(2)(ii) [pg. 315].

Schedule of payments do not fail to be annuities or installments merely because the plan provides for a lump sum payment of all remaining payments if the present value of the remaining payments falls below a predetermined amount within the 402(g) limit set by Reg. § 1.409A-3(j). Treas. Reg. §§ 1.409A-2(b)(2)(ii) [pg. 315] and 1.409A-2(b)(iii) [pg. 318].

[66] Treas. Reg. § 1.409A-2(b)(2)(ii) [pg. 315]. The requirement of spousal consent is not relevant. In determining whether a payment form is an exempt life annuity certain features (such as term-certain features, pop-up features, cash refund features) are disregarded. Id. (Also, treating a life annuity as a series of payments would lead to difficulty in applying the above rules, because the aggregate amount and duration of the payments are unknown, as their continuation depends on the continued life of the individual. Id.)

Under Treas. Reg. § 1.409A-2(b)(2)(ii) [pg. 315] there may be a right to cash out remaining installments or lump sums if falls below any predetermined amount. See also ABA JCEB Q&As for IRS (2008) Q&A 25.

[67] Code § 409A(a)(2)(A)(iv); Treas. Reg. §§ 1.409A-3(a)(4) [pg. 331] & -3(i)(1) [pg. 340].

A plan provides for a specified time or fixed schedule where, at the time of the deferral, the specific date upon which the payment or payments will be made may be determined pursuant to an objective nondiscretionary formula specified at the time the amount is deferred and the amount is objectively determinable. Treas. Reg. § 1.409A-3(i)(1)(i) [pg. 341]. The amount is not objectively determinable if the amount of payment is based on a change in control or other event. Id.

See ABA JCEB Q&As for IRS (2008) Q&A 42 that in certain instances a stream of payments made so long as the employee is disabled could be considered a fixed schedule.

Amounts payable upon the occurrence of an event of the employer (including a transaction by or payment to the employer) are not treated as amounts payable at a specified time, as stated in the Conference Report and Treas. Reg. § 1.409A-3(i)(1)(i). A plan may provide that a payment once vested will be made in accordance with a fixed schedule that is objectively determinable based on the period of vesting, provided the schedule is fixed. Id.

A schedule of payments does not fail to be a fixed schedule where the amount that may be paid is limited by an objective formula or a specified amount that is not under control of the employee, not subject to the discretion of the employer, and the limit is established at time of deferral. Treas. Reg. § 1.409A-3(i)(1)(ii) [pg. 342].

A choice to elect lump sum or installments would not be a specified time or fixed schedule.

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Payment schedules determined by timing of payments received by the employer (back to back payments, e.g., by investment managers of hedge funds) would meet the requirements of a specified date or fixed schedule if the payments to the employer are routine bona fide payments, the employee does not have control of the employer or the payor of such payments, the payment schedule provides objective and nondiscretionary methods for identifying the payments to the employer from which the amount paid to the employee is determined, and the payment schedule provides objective and nondiscretionary schedules for payments to the employee, and the payments to the employer result from sales of a type that employers in that trade or business make.[69] See below, however, that the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 adds new Code § 457A, which is aimed at managers of offshore investment funds, generally eliminates the ability of taxpayers to defer compensation for services performed after December 31, 2008 for certain offshore entities - referred to as "nonqualified entities" (e.g., offshore hedge funds) to the extent such compensation is no longer subject to a substantial risk of forfeiture.

Permissible Distribution Event – (ii) Separation from Service. Distributions may be made on separation from service (or six months after separation from service for key employees of public companies, as described below).[70] A separation from service occurs if the employee dies, retires, or otherwise has a termination of employment, but not while on a bona fide leave of absence (of not more than six months or the employee has a legal right to reemployment).[71] The definition of separation from service should be set forth in the plan document. Whether a termination of employment has occurred is determined based on whether the facts and circumstances indicate that the employer and employee reasonably anticipated either that no further services will be performed after a certain date, or that the level of bona fide services the employee will perform after that date (as an employee or an independent contractor) would permanently decrease to no more than 20% of the average level of bona fide services performed over the immediately preceding three years (or full period of employment less than three years).[72]

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A schedule of payments does not fail to be a fixed schedule of payments where the amount of aggregate payments to be made during the period to all participants is limited by an objective nondiscretionary formula or specified amount not controlled by the employee and certain other requirements are met. Id.

68 Id. However, the subsequent deferral rules of Code § 409A(a)(4)(C)(iii) (that subsequent elections must be made not less than 12 months prior to the first scheduled payment) would require a specific date for the first scheduled payment. If a plan does not designate a specific date, the first scheduled payment is deemed to be scheduled for the first day of such taxable year. Id.

69 Treas. Reg. § 1.409A-3(i)(1)(iii) [pg. 345].

70 Code §§ 409A(a)(2)(A)(i) & (B)(i); Treas. Reg. § 1.409A-3(a)(1) [pg. 331].

71 Treas. Reg. § 1.409A-1(h)(1)(i) [pg. 269]. An employment relationship is treated as continuing while the individual is on sick leave, or other bona fide leave of absence, if the period of such leave does not exceed six months, or if longer, so long as the individual retains a right to reemployment with the service recipient under an applicable statute or by contract and there is a reasonable expectation that the employee will return to perform services for the employer. Treas. Reg. § 1.409A-1(h)(1)(i) [pg. 270].

72 Treas. Reg. § 1.409A-1(h)(1)(ii) [pg. 270]. The regulations list facts and circumstances to be considered in making this determination, including whether services did in fact drop to a level of 20% of that performed in the preceding three years. Id. A plan may treat another level of anticipated reduction as a separation from service,

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If the service provider is an independent contractor, the 80% reduction will not suffice and expiration of the contract (without renewal) is required. [73] The regulations allow a permissive use of the same desk rule, so that parties to an asset sale agreement could agree whether or not the asset sale will be treated as a separation from service.[74] A plan could contain a narrower definition of separation from service than under 409A, because any payment made on such event would fit within a 409A separation from service.

Deferred compensation plans should be written to pay at a specified age or at termination of employment, so that even if the age trigger could not be amended without a five-year delay, the termination of employment trigger would still remain intact.

Permissible Distribution Event – (iii) Disability. Distributions may be made on disability.[75] An employee is disabled if as a result of physical or mental impairment that can result in death or last a year or more: (i) the employee is unable to engage in any substantial gainful activity, or (ii) the employee is receiving income replacement benefits from insurance for three months or more.[76] A plan can provide for a narrower definition of disability as long as any disability upon which a payment may be made fits within a 409A disability category.[77] Payment must be on account of disability and not on some other event (such as termination) after disability unless it meets the requirements for separation from service and the six-month delay requirement

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provided the level of reduction required is set in the plan as a specific percentage of greater than 20% and less than 50%. Id.

73 Treas. Reg. § 1.409A-1(h)(5) [pgs. 277-278].

Where an employee changes status to become an independent contractor (e.g., former executive becoming a consultant) there should be separation from service under § 409A if the services are reduced to 20% or less.

74 Treas. Reg. § 1.409A-1(h)(4) [pg. 276]. These regulations provide that where as part of an asset sale an employee (or other service provider) of the seller retains the same job at the buyer, the seller and buyer can specify in the asset sale agreement (or other agreement prior to closing) whether or not such employees who continue “at the same desk” with the buyer will be treated as separated from service with the seller for purposes of the nonqualified deferred compensation plan, provided that all the employees who continue at the buyer are treated consistently and the asset sale results from bona fide arm’s-length negotiations.

75 Code § 409A(a)(2)(A)(ii). See Treas. Reg. § 1.409A-3(a)(2) [pg. 331].

76 Code § 409A(a)(2)(C); Treas. Reg. § 1.409A-3(i)(4)(i) [pg. 355]. A plan can provide that an employee will be deemed disabled if (i) determined to be totally disabled by the Social Security Administration, or (ii) determined to be disabled by a disability insurance policy (provided such definition is not broader than the definition in the above regulation). Treas. Reg. § 1.409A-3(i)(4)(ii) [pg. 355].

Since there are various alternatives, the definition of disability (and whether termination is also required) should be specified in the agreement.

77 Treas. Reg. § 1.409A-3(i)(4)(ii) [pg. 355].

Using a narrower definition of disability is presumably not considered an impermissible toggle.

is complied with, as noted by IRS officials.[78] In addition, as discussed below, if payment after disability is made only on subsequent termination, it must be the same time and form of payment as on termination alone, as disability is not excepted from the toggle rule discussed below. On the other hand, making disability by itself a payment trigger would require using the somewhat narrow definition of disability in the regulations, and also does not reflect the typical arrangement where the employer only wants to pay for disability once the employee has been terminated.

Permissible Distribution Event – (iv) Death. Distributions may be made on death.[79]

Permissible Distribution Event – (v) Change in Control. Distributions may be made on a change in control of the corporation (which includes change in the ownership or effective control of the corporation, or change in the ownership of a substantial portion of the assets of the corporation).[80] Change in control includes: (A) a "change in the ownership" of the corporation, which occurs when a person or group acquires more than 50% of the value or voting power of the corporation's stock; (B) a "change in effective control" of the corporation, which occurs when a person or group acquires during a 12-month period 30% or more (as opposed to 20% for Code § 280G) of the voting power of the corporation's stock, or during a 12-month period a majority of the corporation's board is replaced by persons not endorsed by the current board; or (C) a "change in ownership of a substantial portion of a corporation's assets," which occurs when a person or group acquires 40% or more (as opposed to 33-1/3% for § 280G) of the total gross fair market value of the assets of the corporation.[81] The Final Regulations allow the nonqualified

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78 See ABA JCEB Q&As for IRS (2008) Q&A 40, that disability can be a different payment event allowing a different distribution form, as long as it is payable on a § 409A disability alone and does not require separation from service.

79 Code § 409A(a)(2)(A)(iii); Treas. Reg. § 1.409A-3(a)(3) [pg. 331]. Distributions on death are subject to § 409, and are different than the exemption for death benefits under Code § 409A(d)(1) and Treas. Reg. § 1.409A-1(a)(5) [pg. 200].

Payments on account of death must be made within 90 days of death or within the same calendar year of death. See Treas. Reg. § 1.409A-3(b) and (d) [pages 332 and 335].

80 Code § 409A(a)(2)(A)(v); Treas. Reg. § 1.409A-3(a)(5) [pg. 331] & -3(i)(5) [pg. 356].

81 Treas. Reg. § 1.409A-3(i)(5)(v)-(vii) [pgs. 361-365]. Change in control is defined in a manner similar to the regulations under Code § 280G, but somewhat more restrictive (as contemplated by the Conference Report), and therefore the percentage changes of ownership are higher.

Unlike the golden parachute provisions, a change in control event may occur that does not relate to the entire affiliated group. The relevant analysis is whether the change in control event relates to: (i) the corporation for whom the services were performed at the time of the event; (ii) the corporation that is liable for the payment (provided there is a bona fide business purpose for such corporation to be liable); or (iii) a corporation that is a majority shareholder of the above corporations. Treas. Reg. § 1.409A-3(i)(5)(ii) [pg. 357]. (This is the one area where § 409A's definition is not more restrictive then § 280G.) The occurrence of the event must be objectively determinable and any requirement that the plan administrator or compensation committee certify the occurrence of a change in control must be strictly ministerial and not involve any discretionary authority. Treas. Reg. § 1.409A-3(i)(5)(i) [pg. 356].

Neither the statute nor the legislative history refers to a permissible distribution upon a change in control of any type of entity other than a corporation. However, the Preamble to the Proposed Regulations notes that the IRS plans to issue regulations that will allow an acceleration of payments upon a change in control of a partnership, and until further guidance is issued, the rules in Prop. Reg. § 1.409A-3(i)(5)(v) & (vii) [pgs. 361-365] may be

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deferred compensation plan to use higher thresholds for change in control, such as a percentage for change in ownership to be higher than 50%, change in effective control to above 30%, majority change in board of directors, etc.[82] In general, if a plan contains a narrower definition of change in control than 409A, that should suffice, because any payment made on such change in control would fit within a 409A category of change in control.[83]

An acquisition by the Treasury of equity in financial institutions under the TARP program will not be considered a change in control distributable event under § 409A.[84]

Note that if the plan only pays out on a double trigger (change in control and termination) and the second trigger of termination satisfies the § 409A definition of separation from service, there should be no need to separately conform change in control to the § 409A definition (even if the change in control alone triggers vesting but not payout), unless it is needed to meet the change in control exception to the "toggling" restrictions discussed below.

Permissible Distribution Event – (vi) Unforeseeable Emergency. Distributions may be made on an unforeseeable emergency, which is defined as a severe financial hardship to the participant resulting from (A) an illness or accident of the participant, spouse, beneficiary or

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applied by analogy to changes in the ownership of a partnership and changes in the ownership of a substantial portion of the assets of a partnership, with any reference to "majority shareholder" applied by analogy to the owner of a partnership who owns more than 50% of the capital and profits interests of such partnership, and alone or together with others is vested with the continuing exclusive authority to make the management decisions necessary to conduct the business for which the partnership was formed. The Preamble to the Final Regulations (§ IIIG) also reserve the treatment of § 409A and partnerships.

The Preamble to the Final Regulations, IV.F [pg. 136] states that with respect to the application of the change in control provisions to non-stock, non-profit corporations, the Treasury and IRS are considering whether such guidance is appropriate, and if so what types of changes could be treated as analogous to a change in control event involving a stock corporation. Until further guidance, a non-stock, non-profit corporation may apply the change in effective control provisions in § 1.409A-3(i)(5) (relating to a change in the composition of the board of directors) by analogy to changes in the composition of its board of directors, trustees, or other governing body. Id.

Regarding transaction-based compensation as it applies to the above rules, see Treas. Reg. § 1.409A-3(i)(5)(iv) [pg. 358].

82 Treas. Reg. § 1.409A-3(i)(5) [pg. 356].

83 Id.

Using a narrower definition of change in control is presumably not considered an impermissible toggle.

84 Notice 2009-49. Under the Troubled Asset Relief Program (TARP) of the Emergency Economic Stabilization Act of 2008 (EESA), the Treasury Department is authorized to make acquisitions of equity (e.g., common stock, preferred stock or warrants) in troubled financial institutions. The notice provides that an equity acquisition under TARP is not a change in control under § 409A. (As the notice states, to allow a TARP equity acquisition to be a distributable event under a 409A nonqualified deferred compensation arrangement would reduce liquidity and would therefore be contrary to the purposes of EESA.) As stated in the notice, the plan document does not need to explicitly exclude TARP acquisitions from the definition of change in control. The notice does not address whether a TARP equity acquisition will be a change in control for other purposes. Therefore, change in control agreements may need to be amended to explicitly exclude TARP equity acquisitions

dependent, (B) a loss of the participant's property due to casualty, or (C) other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of participant.[85]

Different Payments for Different Events and "Toggling". The regulations permit a plan to provide that payments may be made upon the earliest of, or the latest of, two or more specified permissible payment events or times.[86] Thus, one payment method could be allowed on separation from service and another for other events. This is only true for different distribution events. For a single distribution event, a single time and form of payment must be designated (except as provided below).[87] This prohibition on multiple payment times and forms is often referred to as "toggling".

This anti-toggling rule applies to each of the following distribution events of (i) separation from service, (ii) disability, (iii) death, (iv) change in control or (v) unforeseeable emergency.[88] It does not apply, however, to distributions at a specified date or pursuant to a fixed schedule.[89]

The regulations provide an exception to the no-toggling rule, that a plan may provide for a different time and form of payment depending on whether the payment event occurs before or after a specified date, or based on conditions under which a separation from service occurs.[90] Specifically, the

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85 Code §§ 409A(a)(2)(A)(vi) & 409A(a)(2)(B)(ii); Treas. Reg. §§ 1.409A-3(a)(6) [pg. 331] & -3(i)(3)(i) [pg. 352]. For example, the imminent foreclosure of the employee's primary residence may constitute an unforeseeable emergency. The need to pay for medical expenses, including non-refundable deductibles and the costs of prescription drugs may constitute an unforeseeable emergency. The need to pay for the funeral expenses of a spouse, a beneficiary, or a dependent may also constitute an unforeseeable emergency. The purchase of a home and the payment of college tuition are generally not unforeseeable emergencies. Treas. Reg. § 1.409A-3(i)(3)(i) [pg. 352-3].

The amount of distribution must be limited to the amount necessary to satisfy the emergency and pay taxes, and distributions may not be allowed to the extent the hardship may be relieved through reimbursement by insurance or otherwise or by liquidation of the participant's assets. Code § 409A(a)(2)(B)(ii)(II); Treas. Reg. § 1.409A-3(i)(3)(ii) [pg. 353].

These unforeseeable emergency rules are more limited than the 401(k) hardship distribution rules which need not be unforeseeable.

86 Treas. Reg. § 1.409A-3(b) [pg. 332]. See also, Treas. Reg. § 1.409A-2(b)(6) [pg. 321].

See, e.g., ABA JCEB Q&As for IRS (2008) Q&A 21. See also Q&A 38 regarding payment upon the "earliest of" rule. See also Q&A 41 that it would not be permissible for a person to provide a joint and survivor annuity if married and a lump sum if unmarried, because marriage status is not a permissible toggle under Treas. Reg. § 1.409A-3(c).

87 Treas. Reg. § 1.409A-3(c) [pg. 333]. See ABA JCEB Q&As for IRS (2008) Q&A 39 that different RSUs could have different payment terms even though RSU type plans are aggregated, because amounts scheduled on different times can each have different payment terms.

88 Treas. Reg. § 1.409A-3(c) [pg. 333].

89 This is probably because a fixed schedule has built into it alternate payments that are set in the original fixed schedule.

90 Treas. Reg. § 1.409A-3(c) [pg. 333]. IRS officials have indicated, however, that one cannot provide for different forms of payment depending on whether or not the employment termination is voluntary or not.

regulations provide that the time and form of payment upon a separation from service may vary depending on (i) whether the separation from service occurs during a limited period of time not to exceed two years following a change in control event (assuming the change in control meets the § 409A definition or is not more expansive than the 409A definition),[91] and/or (ii) whether the separation from service occurs before or after a specified date (for example, the attainment of a specified age) or before or after a combination of a specified date and a specified period of service determined under a predetermined objective formula or pursuant to the method of crediting service under a qualified plan.[92] If using the change in control exception to toggling, the change in control definition must conform with the requirements under Code § 409A(a)(2)(A)(v) even if the change in control is not the payment trigger.

If a payment form for disability is only made on separation from service, and a different payment form is made on separation from service without a prior disability this will be an impermissible toggle, since disability is not excepted from the "toggle" rule.[93] If, however, the payment is made upon disability alone and without any condition of separation from service (and disability conforms with the § 409A definition) then the different forms of payment can be made since disability is a separate payment event from separation from service.

Designated Payment Dates Within One Calendar Year, 90 Day Payment Period, etc. The Final Regulations provide that a payment is treated as made "upon" a payment event (i.e., any of the payment events in § 409A(a)(2)(A), including on a fixed date or fixed schedule) if the payment is made on such date or a later date within the calendar year in which the event occurs or, if later, by the 15th day of the third month following the date in which the event occurs (and the employee is not provided an election as to year of payment).[94] A payment will be deemed made at the scheduled time of payment if made not earlier than 30 days before the scheduled date, provided that the employee is not permitted to designate the taxable year of payment.[95]

In addition, the regulations provide that where the time of payment is based upon the occurrence of a specified event other than a fixed time or schedule (i.e., upon the occurrence of a separation from service, disability, death or change in control), the plan may provide as a payment date: (i) a payment date that is objectively determinable and nondiscretionary at the time the event occurs; (ii) a schedule that is objectively determinable and nondiscretionary based on the date the event occurs and would qualify as a fixed schedule if the payment event were a fixed date; (iii) a designated calendar year; (iv) a designated period that begins and ends within the same calendar year, or (v) a designated period of not more than 90 days and the employee cannot designate the taxable year of payment, provided that in

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[91] Presumably, even if the plan definition of change in control is narrower than the 409A definition, this would still make it a good toggle, because the plan's definition of change in control is a good 409A change in control.

[92] Treas. Reg. § 1.409A-3(c) [pg. 333]. The addition or deletion of the different time and form of payment applicable to an existing deferral is subject to the subsequent deferral and anti-acceleration rules. Id.

[93] Note that payment of one year of severance over 12 months for termination and two years severance over 24 months for termination due to disability would not be an impermissible toggle, because the form of payment (monthly payments of one month severance) is not changing.

[94] Treas. Reg. § 1.409A-3(d) [pg. 335]. See also Preamble to Final Regulations, VII.A. [pg. 95]. A plan may designate an entire taxable year of the employee, rather than a specific date, as the specified date of payment.

[95] Treas. Reg. §1.409A-3(d) [pg. 335].

each case the payment date is objectively determinable (and the employee is not provided an election as to the year of the payment).[96]

Six-Month Waiting Period after Separation From Service for Specified Employees (Top 50) of Public Companies. Although distributions of deferred compensation subject to § 409A may be made upon separation from service, there is a special rule for separation from service for "specified employees" of a corporation whose stock is publicly traded on an established securities market,[97] that the distribution cannot be made until six months after separation from service.[98] "Specified employee" is a key employee under Code § 416(i) without regard to paragraph (5) (regarding treatment of beneficiaries) of a service recipient, which is generally employees who are the top 50 executives earning over $130,000 (as indexed; $160,000 in 2010).[99] "Service recipient" is the entity for whom services are performed and

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[96] Treas. Reg. § 1.409A-3(b) [pg. 332].

For example, a payment scheduled to be made at any time on or after January 1, 2008, and on or before July 1, 2008, to a service provider whose taxable year is the calendar year will be deemed to have a fixed payment date. For purposes of the subsequent deferral rules, January 1, 2008, is the specified payment date. By contrast, a payment scheduled to be made to such a service provider at any time on or before July 1, 2008, would not be deemed to have a fixed payment date, because the payment could be made before January 1, 2008. In addition, a payment scheduled to be made to a service provider, for example, within 180 days of a separation from service generally will not provide for a specified time and form of payment under the Final Regulations, because it specifies neither the taxable year of the service provider in which the payment must be made following the separation from service, nor a period of 90 days or less following the separation from service in which the payment must be made. Preamble to Final Regulations, VII.A. [pg. 97].

The first possible date on which a payment could be made under the plan is the specified payment date (e.g., for purposes of the rules relating to subsequent deferral elections). Treas. Reg. § 1.409A-3(b) [pg. 333].

Note that the above regulations allow designated payment by merely specifying the year in which the payment will be made without specifying the date.

Note also, that a taxable year of the employee would generally be the calendar year.

[97] Established securities market is defined by reference to Treas. Reg. § 1.897-1(m), which generally includes foreign securities markets. Treas. Reg. § 1.409A-1(k) [pg. 289] (definition of "established securities market," which is used in Treas. Reg. § 1.409-1(i) [pg. 279] for definition of "specified employee") and Preamble to Final Regulations.

[98] Code § 409A(a)(2)(B)(i); Treas. Reg. § 1.409A-3(i)(2)(i) [pg. 351].

[99] Code § 409A(a)(2)(B)(i); Treas. Reg. § 1.409A-1(i)(l) [pg. 279].

A key employee under § 416(i) is an employee who is: an officer with annual compensation greater than $130,000 (as indexed - $150,000 in 2008) but no more than 50 employees or 10% of employees (whichever is less) are treated as officers; a 5% owner, or a 1% owner with annual compensation greater than $150,000. Note that officers of subsidiaries could also be part of the top 50 officers. Code § 416(i); Treas. Reg. § 1.416-1 Q&A T12 - T20.

The general definition of compensation under Treas. Reg. § 1.415(c) -2(a) applies (but without safe harbor, timing or other special rules under § 1.415(c) -2(d), (e) and (g)) Treas. Reg. § 1.409A-1(i)(2) [pg. 280]. However, the employer has the option of using any available definition of compensation under § 415 as long as provided consistently to all employees. Treas. Reg. § 1.409A-1(i)(2) [pg. 280].

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all other entities that are in the service recipient's controlled group as determined under Code § 414(b) or (c).[100]

To meet the six-month delay requirement, a plan may provide that any payment pursuant to a separation of service due within the six-month period is delayed until the end of the six-month period, or that each scheduled payment that becomes payable pursuant to a separation from service is delayed by six months, or a combination thereof.[101] Payment of the distribution amount (e.g., severance) is often put into a "rabbi trust" that would pay out the amount of severance after six months. Such an arrangement should satisfy the above requirements.[102] Often the executive will be provided with interest for the six-month delay.

Generally the identification date for determining the specified employees is December 31, although an employer can designate any other date as the specified employee identification date, as long as it is used for all its nonqualified deferral compensation plans and for all employees.[103] Specified employees on the identification date become treated as specified employees for purposes of the six-month delay as of the first day of the fourth month following the identification date, although an employer can designate a different earlier effective date as long as it is not later than the first day of the fourth month.[104] In addition, the employer must use the same specified employee effective date for all its nonqualified deferred compensation plans, and any change to the specified employee effective date may not be effective for a period of at least 12 months.[105] All members of the controlled group must use the same

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The general definition should include W-2 compensation and with similar compensation for foreign employees. (Inclusion of foreign employees limits the number of affected U.S. specified employees, but would become very difficult to calculate with regard to how W-2 type compensation is applied to foreign employees.)

An outside director would not be a specified employee because the director is not an employee.

100 Treas. Reg. § 1.409A-1(g) uses Code §§ 414(b) and (c) affiliate definition. See ABA JCEB Q&As for IRS (2008) Q&A 28 that the service recipient would not include, e.g., a 50% affiliate.

101 Treas. Reg. § 1.409A-3(i)(2)(ii) [pg. 351]. (A plan may be amended to specify or change the manner in which the delay will be implemented, provided that the amendment may not be effective for at least 12 months. See similarly, Treas. Reg. § 1.409A-2(b)(i) [pg. 313].) An employer may retain the election as to the manner in which the six-month delay is to be implemented, provided that such election is subject to otherwise applicable deferral election rules. Treas. Reg. § 1.409A-3(i)(2)(ii) [pg. 352].

See also Treas. Reg. § 1.409A-1(c)(3)(v) [pg. 257] that a plan must specifically provide that distributions to specified employees may not be made for the first six months after separation from service.

See ABA JCEB Q&As for IRS (2008) Q&A 36, that a plan may provide that the six month delay will apply only to deferred compensation subject to § 409A. However, if the plan provides that the six month delay applies to all distributions then even amounts that would be short-term deferrals without the six month delay would become subject to § 409A because the six-month delay causes them not to be short-term deferrals.

102 A rabbi trust is a grantor trust subject to the claims of creditors in bankruptcy.

103 Treas. Reg. § 1.409A-1(i)(3) [pg. 280].

104 Treas. Reg. § 1.409A-1(i)(4) [pg. 281].

105 Treas. Reg. § 1.409A-1(i)(4) [pg. 282].

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definition of specified employee. Elections regarding identification of specified employees are only effective once corporate action has been taken to make the elections binding on all the affected plans,[106] (and presumably must be adopted before the specified employee effective date). These elections are often effectuated by corporate resolutions or a policy adopted by resolution.[107] Regarding identifying specified employees following a corporate transaction, the Final Regulations offer significant flexibility.[108]

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A plan may provide for an alternative method to identify specified employees that can be utilized, provided it is reasonably designed to include all those who would be specified employees under the general rules, the method is an objectively determinable standard and generally no more than 200 employees may be identified as specified employees. Treas. Reg. § 1.409A-1(i)(5) [pg. 282].

[106] Treas. Reg. 1.409A-1(c)(8) [pg. 288].

[107] It is often desirable to state in the plans that specified employee will be determined as defined by the Board, and then have the separate resolution of the Board, so that the definition can be changed without having to amend the various plans.

[108] Where two public companies merge, or a public company becomes a subsidiary of another public company, the regulations provide that the resulting employers' next specified employee identification date and effective date are the employee identification date and effective date that the acquiring employer used. Treas. Reg. § 1.409A-1(i)(6)(i) [pg. 283]. For the period after the closing but before the next specified employee effective date, the specified employees of Newco consists of the 50 most highly compensated employees appearing on the combined lists of the employers' specified employees in effect as of the date of the transaction, ranking such specified employees generally in order of the amount of compensation used to determine their status as a specified employee. Id. Alternatively, the employer may use any other reasonable method to determine specified employees immediately after the transaction, provided that such method is adopted within 90 days after the transaction and applied prospectively from the date of adoption. Id.

Where a public and private company merge and become a public company, or where a private company becomes a subsidiary of a public company, the resulting employer's next specified employee identification date and specified employee effective date following the transaction will be the identification date and effective date that the pre-transaction public company used. Treas. Reg. § 1.409A-1(i)(6)(ii) [pg. 284]. For the period after the transaction and before the next specified employee effective date, the specified employees of the pre-transaction public employer immediately prior to the transaction will continue to be the specified employees of the resulting employer, and employees of the pre-merger private employer will not become specified employees until the next specified employee effective date. Id. (The nonqualified deferred compensation plans in which employees of the formerly private employer participate will not be required to contain a plan term delaying a payment upon separation from service of such employees. Preamble to Final Regulations.)

Regarding spin-offs, where a public employer becomes two separate public employers, the next specified employee identification date and effective date of each of the post-transaction employers is the specified employee identification date and specified employee effective date that the pre-transaction employer used. Treas. Reg. § 1.409A-1(i)(6)(iii) [pg. 285]. For the period after the transaction and before the next specified employee effective date, the specified employees of the pre-transaction employer immediately prior to the transaction continue to be the specified employees of the post-transaction employer. Id.

Regarding IPOs, the regulations provide that where on initial public offerings and other corporate transactions all or part of a private service employer becomes public, each post-transaction public employer will have a December 31 specified employee identification date and an April 1 specified employee date. Treas. Reg. § 1.409A-1(i)(6)(iv) [pg. 286]. Alternatively, the new public employer may establish a different specified

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Expense Reimbursements Within the Year Following Year of Expense; Medical Reimbursements, Tax Gross-Ups and In-Kind Benefits for Employees. The Preamble to the Final Regulations provides that the right to reimbursement will not generally meet the 2 ½ month short-term deferral rule, because the risk that an employee will fail to incur a reimbursable expense will not qualify as a substantial risk of forfeiture, and therefore § 409A would be applicable.[109] There are, however, broad rules for reimbursement arrangements to meet the specified date/fixed payment schedule requirement of § 409A.

Reimbursements of expenses and payment of in-kind benefits will be considered as being made at a specified date/fixed schedule if all of the following conditions are met: (i) the plan provides an objectively determinable nondiscretionary definition of expenses eligible for reimbursement of expenses or of the in-kind benefits to be provided, (ii) the plan provides for reimbursement of expenses or for provision of in-kind benefits during an objectively and specifically provided period (including during the lifetime of the employee),[110] (iii) the plan provides that expenses eligible for reimbursement or the provision of in-kind benefits during a taxable year may not affect expenses eligible or in-kind benefits available in any other year (so could not have a lifetime max), (iv) the reimbursement of eligible expenses is made by end of the employee's taxable year (which for individual employees is generally the calendar year) following the year in which the expense was incurred, and (v) the right to reimbursement of expenses or to in-kind benefits is not subject to liquidation or exchange for another benefit.[111]

"In-kind benefits" refer to services provided to an employee or other service provider, such as financial planning services, or tangible personal or real property made available for use by or on behalf of the employee, such as the use of an aircraft or vehicle, and does not refer to a transfer of property within the meaning of Code § 83 or a promise to transfer, or an option to purchase or receive, property in the future.[112]

Medical reimbursement arrangements can meet the above requirements for a fixed time or schedule if they meet the above requirements for general reimbursement (i.e., up to end of the employees' taxable year after year in which the benefits were incurred), although they do not have a restriction on multi-year maximums.[113] Note also that the medical reimbursement exception is only needed for medical plans that are taxable under IRC § 105 because they fail the nondiscrimination rules

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employee identification date and effective date, provided that the identification date and effective date must be established on or before the date of the initial public offering. Id.

109 This is not an issue for nontaxable benefits since nontaxable benefits are not subject to § 409A. See also Treas. Reg. § 1.409A-1(b)(1) [pg. 201] that a legally binding right to receive a nontaxable benefit is not a deferral of compensation. However, the rules below are necessary for taxable benefits.

110 Thus, for example, expenses could be limited to the period of employment. Legal expenses could be limited to, e.g., within 20 years after termination of employment (or during the employee's life).

111 Treas. Reg. § 1.409A-3(i)(1)(iv) [pg. 346].

Note that reimbursements that meet the above rules do not have an issue regarding the six month wait because payments are not made on account of termination of employment, but rather on a specified date/fixed schedule.

112 Treas. Reg. § 1.409A-1(p) [pg. 295].

113 Treas. Reg. § 1.409A-3(i)(1)(iv)(B) [pg. 347]. Thus, medical benefits can have a lifetime cap so that benefits of one year can affect benefits under another year.

of § 105(h) where only senior executives receive the retiree health as part of severance (and discriminates in eligibility under § 105(h)).[114] The executive purchasing and being reimbursed for individual insured health coverage may not be sufficient to avoid application of IRC § 105(h). Prior to the Patient Protection and Affordable Care Act of 2010 (the "Affordable Care Act"), IRC § 105(h) only applied to self-insured plans, and the executive could purchase individual insured health coverage and be reimbursed for the premiums.[115] Under the Patient Protection Affordable Care Act of 2010, insured plans are now also subject to § 105(h) nondiscrimination rules except for grandfathered plans where the insured plans were in existence on March 23, 2010.[116] Thus, with regard to self-insured plans or new insured plans, the post-employment "benefits" (and not merely premiums) received only by the executives would be taxable to them. As an alternative, for self-insured or new insured plans the employer should be able to reimburse the COBRA costs or costs of private insurance, provided this is done on a taxable basis. Alternatively, the employer could increase the cash severance, and the executive could purchase individual coverage which would not be a group health plan and would not be subject to nondiscrimination rules, although in such case this payment would be added to the regular severance for purposes of, e.g., meeting the two years two times pay exception, and such additional payments would of course be taxable.

If the medical reimbursement arrangement is nontaxable under § 105 then it is entirely exempt from § 409A under Treas. Reg. § 1.409A-1(a)(5), as discussed above.[117] See also discussion below regarding medical reimbursements in severance arrangements.

The above exceptions for reimbursement of expenses, in-kind benefits and reimbursement of medical benefits can apply whether made in-service or after termination of employment. In addition reimbursements that meet the above rules would not have to apply the six-month delay for specified employees of public companies, because payment is considered to be made at a specified date/fixed schedule, and the six-month delay only applies to payment on separation from service.

There is another set of exceptions for reimbursements of certain expenses that would be nontaxable or certain medical benefits paid on account of termination of employment if they meet certain requirements, as discussed below.[118] Those exceptions cause the arrangements to not be subject to § 409A at all, and for that reason do not have to comply with the six-month rule even though made upon separation from service.

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114 Note that the above regulations regarding reimbursements of expenses and in-kind benefits require objectively determinable nondiscretionary definition of expenses eligible for reimbursement. The medical policy should be able to meet this requirement.

115 See 2003 ABA JCEB/IRS Q&A 7. See also, Paul Hastings Jan. 2009 memo, Tax Risks of Providing Self-Insured Health Plan Benefits to RIF'd Executives, www.paulhastings.com/assets/publications/1164.pdf?wt.mc_ID=1164.pdf

116 Patient Protection and Affordable Care Act of 2010 §§ 1001 & 1562 add IRC § 9815 and ERISA § 715, which incorporate by reference § 2716 of the Public Health Service Act that insured plans that are not grandfathered may not establish eligibility rules that discriminate in favor of higher wage employees. Failure will result in a $100 a day penalty for each individual to whom the failure relates for the failure period. IRC § 4980D(b)(2). There may be an exemption from excise tax for employers with not more than 50 employees.

117 Treas. Reg. § 1.409A-1(a)(5) [pg. 200]. (The nondiscrimination rules of Code § 125 only apply to the deductibility of employee premiums under a pre-tax premium or cafeteria plan, and do not impact the nontaxability of the medical benefits themselves.)

118 Treas. Reg. § 1.409A-1(b)(9)(v) [pg. 245], discussed below.

Tax gross-up up payments will be treated as providing payment at a specified date or fixed schedule if the payments are made under the plan by the end of the employee's taxable year following the year in which the taxes are remitted and the definition of expenses is objectively determinable.[119] The six-month delay for key employees should generally not apply to gross-up payments because they are not directly triggered by separation from service. However, an IRS official has indicated that if the gross-up is triggered by a separation from service then even if the gross-up would also apply without separation (e.g. for stock option vesting on single trigger) it would still be a payment on separation from service and requires a six-month delay.

There may also be an issue with 280G cutbacks that allow the employee the discretion as to what payment to cut back first, because this may be viewed as a late election. However, such an election could also be viewed only as a forfeiture of the deferred compensation rather than a further deferral. So it would be preferable to specify in the agreement which payments are cut back first.

Note that reimbursement of expenses and rights to in-kind benefits are a separate type of plan for aggregation requirements, as discussed above,[120] and therefore as long as these specific types of fixed payment requirements are met, there are no other § 409A requirements, as the six-month delay is only applicable to payments on separation from service.

Delay in Payment by Employee to Comply with Other Laws. The regulations provide that in the case of payments the deduction for which would be limited by Code § 162(m) or payments that would violate securities and other laws, the payments may be delayed without violating Code § 409A.[121]

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[119] Treas. Reg. § 1.409A-3(i)(1)(v) [pg. 347]. The above regulations provide that for these purposes tax gross-up payment refers to a payment to reimburse the employee in an amount equal to all or a designated portion of the Federal, state, local, or foreign taxes imposed upon the employee as a result of compensation paid to the employee by the employer, including the amount of additional taxes imposed upon the employee due to the employer's payment of the initial taxes on such compensation. Id.

The regulations permit reimbursement for amount equal to taxes actually imposed on the employee. Treas. Reg. § 1.409A-3(i)(1)(v) [pg. 347]. According to IRS officials, there cannot be reimbursement at the highest marginal rate of tax, but may be a good faith effort to estimate the actual rate that will be imposed on the employee.

Reimbursement of expenses due to a tax audit or litigation addressing amount of tax liability, will be fixed time/form of payment as long as the agreement provides that payment will be made by the end of the employees taxable year following the year in which the taxes are remitted, the audit is completed or there is a final nonappealable settlement or resolution of the litigation. Treas. Reg. § 1.409A-3(i)(1)(v) [pg. 347-348].

In terms of severance plans exempt from § 409A because of the short-term deferral rule, the gross-up payments (which are treated as severance under Treas. Reg. § 1.409A-1(b)(9) [pg. 241]) will also be exempt if they are required to be paid with the 2 ½ month short-term deferral period.

It would appear that the requirements of Treas. Reg. § 1.409A-3(i)(1)(v) [pg. 347] could be met where there is a modified gross-up with a cutback (if there would be no benefit to the employee with the payment over the cutback). See also, Treas. Reg. § 1.409A-3(i)(1)(vi).

[120] Treas. Reg. §1.409A-1(c)(2) [pg. 250].

[121] Treas. Reg. § 1.409A-2(b)(7) [pg. 321].

Disputed Payments and Refusals to Pay. Where an employer fails to pay deferred compensation when the payment is due (such as where the obligation to make payment or the amount of payment is in dispute or the employer refuses to pay), the regulations provide that the payment will generally be deemed to be made upon the date scheduled under the terms of the arrangement, provided that the employee is acting in good faith and makes reasonable, good faith efforts to collect the amount.[122]

Written Plan Requirement. The regulations impose a requirement for deferred compensation under § 409A that the plan must be established and maintained by the employer in accordance with the requirements of the § 409A regulations and the material terms must be set forth in writing in one or more documents.[123] The material terms of the plan include the amount (or the formula for determining the amount) to be provided under the plan and the time and form of payment.[124] Initial and subsequent deferral elections, if applicable, must be set forth in writing by the date the applicable election is required to be irrevocable.[125] A plan is not required to set forth in writing the conditions under which a payment may be accelerated if such acceleration is permitted.[126] With respect to specified employees, a plan must provide that distributions to such employees may not be made for the first six months after the separation from service, and such provision must be set forth in writing on or before the date such employee first becomes a specified employee.[127] IRS officials have indicated that incorporation of definitions in 409A regulations by reference would be permitted. If the definitions are incorporated by reference, the default definition will apply, although in certain cases it may be helpful to the plan administrator if the rule is set forth in the plan.

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122 Treas. Reg. § 1.409A-3(g) [pg. 338].

123 Treas. Reg. § 1.409A-1(c)(3) [pg. 256].

124 Treas. Reg. § 1.409A-1(c)(3)(i) [pg. 255]. See also, Treas. Reg. § 1.409A-2(b)(2)(iii) [pg. 318] regarding series of installment payments and § 1.409A-3(a) & (c) [pgs. 331, 333] regarding designating time and form of payment for each distribution event.

Short-term deferral provisions should not have to be in writing since they do not involve 409A requirements.

125 Treas. Reg. § 1.409A-1(c)(3)(ii) & (iii) [pgs. 256-257]; Treas. Reg. § 1.409A-2(a)(3) [pg. 298]. Thus a plan could leave out subsequent elections until the time that it is to be used.

Written plan requirements do not appear to apply to reimbursement of expenses.

126 Treas. Reg. § 1.409A-1(c)(3)(iv) [pg. 257]. See also, ABA JCEB Q&As for IRS (2008) Q&A 20.

127 Treas. Reg. § 1.409A-1(c)(3)(v) [pg. 257]. See also, Treas. Reg. § 1.409A-3(i)(2)(i) [pg. 350] regarding the six-month delay requirement that must be specified, and Treas. Reg. § 1.409A-1(i) [pg. 279] regarding the requirement to specify in the plan or in another document (such as board resolutions) the method of identifying specified employees.

See also, Treas. Reg. § 1.409A-1(h)(1)(ii) [pg. 270] regarding level of reasonably anticipated permanent reduction in level of bona fide services for termination of employment, and Treas. Reg. § 1.409A-1(h)(3) [pg. 275] regarding specifying definition of service recipient if not using 50% controlled group standard).

For purposes of the above, a plan is established on the latest of the date on which it is adopted, the date on which it is effective, and the date on which the material terms of the plan are set forth in writing.[128]

Plan Amendments. In the case of an amendment that increases the amount deferred under a nonqualified deferred compensation plan, the plan is not considered established with respect to the additional amount deferred until the plan, as amended, is established in accordance with the previous paragraph.[129]

Prohibition on Acceleration of Payment. The acceleration of time or schedule of any payment under the plan is not allowed, except as provided by regulations.[130]

Acceleration Permitted by Regulations to Waive Vesting, for De Minimis Payments on Separation From Service, Emergencies, Etc. The regulations provide that the employer waiving or accelerating the vesting of compensation (such as reducing vesting from ten to five years of service) would not be a prohibited acceleration of benefits.[131] The regulations also permit accelerations of payment: (i) to fulfill a QDRO;[132] (ii) for divestitures required for conflict of interest and ethics requirements;[133] (iii) for withholding for a 457(f) plan to pay income tax due on a vesting event;[134] (iv) where the plan requires or gives the employer discretion to require a cash-out a participant's account if it does not exceed a small sum, i.e. an amount no greater than the 402(g) elective deferral limit for 401(k) plans ($16,500 in 2010) and such amount is the participant's entire interest in the plan;[135] (v) to pay FICA

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128 Treas. Reg. § 1.409A-1(c)(3)(i) [pg. 255]. The material terms of the plan include the amount (or the method or formula for determining the amount) of deferred compensation to be provided under the plan and the time and form of payment. Notwithstanding the foregoing, a plan will be deemed to be established as of the date the participant obtains a legally binding right to a deferral of compensation, provided that the plan is otherwise established under the rules of this paragraph (c)(3)(i) by the end of the taxable year of the service provider in which the legally binding right arises. Id.

129 Treas. Reg. § 1.409A-1(c)(3)(vi) [pg. 257].

130 Code § 409A(a)(3). See, Treas. Reg. § 1.409A-3(j)(1) [pg. 369].

IRS officials have indicated that a plan that otherwise pays benefits at a fixed payment date may provide for earlier payments upon one of the other types of termination.

131 Treas. Reg. § 1.409A-3(j)(1) [pg. 369]. However, if the plan had provided for payment at a fixed date rather than at separation from service, the date of payment could not be accelerated. Id. See also Treas. Reg. § 1.409A-3(j)(2) [pg. 371] for application to multiple payment dates.

Haircut provisions where distributions could be made on request subject to a forfeiture of, e.g., 10% would no longer be permissible.

132 Treas. Reg. § 1.409A-3(j)(4)(ii) [pg. 373]. If the plan does not provide for such a distribution for a QDRO, an amendment to so provide may be a material modification after 10/3/04 tainting any grandfather treatment.

133 Treas. Reg. § 1.409A-3(j)(4)(iii) [pg. 373]. See also Notice 2006-64, 2006-29 I.R.B. 88, which clarified this exception for Federal conflict of interest requirements.

134 Treas. Reg. §1.409A-3(j)(4)(iv) [pg. 374].

135 Treas. Reg. § 1.409A-3(j)(4)(v) [pg. 374]. See also Treas. Reg. § 409A-2(b)(2). See also below regarding small sum cashout of severance under Treas. Reg. § 1.409A-1(b)(9)(v)(D) [pg. 747]

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or withholding taxes on the deferred compensation;[136] (vi) where acceleration to pay the amount the employee includes in income is as a result of the plan failing to meet the requirements of § 409A;[137] (vii) for cancellation of deferral elections if an employee obtains a payment upon an unforeseeable emergency or obtains hardship distribution under a 401(k) plan, provided the deferral election is terminated and not merely suspended;[138] and (viii) for an S corporation sponsoring an ESOP where distributions from a nonqualified deferred compensation plan is necessary to avoid a nonallocation year under Code § 409(p)(3).[139]

A change in a beneficiary does not constitute an acceleration of a payment if the change in the time of payment stems solely from the different life expectancy of the new beneficiary.[140]

Acceleration Permitted by Regulations on Plan Termination Where All Such Plans Terminated, Following a Change in Control or in Bankruptcy. The regulations allow a plan to provide for accelerations of payment or a payment to be made, pursuant to a termination or and liquidation of the plan[141] in any of the following cases: (i) within 12 months of a corporate dissolution under bankruptcy, (ii) within 30 days before or 12 months after a change in control, provided all deferred compensation plans that are aggregated for all such employees (under Treas. Reg. § 1.409A-1(c)(2) [pg. 250]) are terminated and liquidated in connection with the change in control, or (iii) pursuant to the employer's discretion to terminate and liquidate the plan, provided that it does not occur proximate to a financial downturn of the company, the employer terminates all arrangements that are aggregated if the same employees had deferrals of income under all the agreements terminated, no payments are made within 12 months of the date the employer takes action to terminate the plan other than payments due in ordinary course, all payments are made within 24 months of the termination, and the employer does not adopt a new arrangement of the same type within three years of the termination.[142] The three-year rule requires due

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Notice 2007-78, Section IV.C provides that until further guidance is issued, a plan may provide for the automatic cashout of amounts above the 402(g) if certain requirements are satisfied: (i) the amount must be designated this year and the ability to change the amount will be severely limited because it can only be changed in accordance with the rules governing subsequent elections and anti-acceleration; and (ii) the plan must require that the benefit be paid in an immediate lump sum if the present value of the participant's benefit is less than the specified amount; no choice or election by either the Company or the employee may be permitted.

136 Treas. Reg. § 1.409A-3(j)(4)(vi) [pg. 375].

137 Treas. Reg. § 1.409A-3(j)(4)(vii) [pg. 376].

138 Treas. Reg. § 1.409A-3(j)(4)(viii) [pg. 376].

139 Treas. Reg. § 1.409A-3(j)(4)(x) [pg. 379]. Note that the acceleration provisions are permissive and a plan can choose some of them but not others. ABA JCEB Q&As for IRS (2008) Q&A 20.

140 Treas. Reg. § 1.409A-3(j)(3) [pg. 371-372].

141 The Preamble to the Final Regulations explains that a termination and liquidation of a nonqualified deferred compensation plan involves both an amendment of the plan to cease deferrals, and providing for payment of all benefits under the plan.

142 Treas. Reg. § 1.409A-3(j)(4)(ix) [pg. 376]. As noted in the regulation and the Preamble to the Final Regulations, the entities comprising the employer are treated as the employer and this rule only applies with respect to those entities that had the change in control event.

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diligence in transactions to make sure a company does not inherit a similar program in the three-year period.

Offsets. A plan may provide for an offset by the employer of debt owed to it by the employee through the reduction of a right to nonqualified deferred compensation payments for up to $5,000 per year.[143] Offsets above this amount will be treated as providing for an acceleration of a payment under the deferred compensation, because they create opportunities to disguise accelerated payments of deferred compensation by offsetting immediately a deferred compensation obligation that may be payable over time.[144]

Substitutions Replacing Arrangements Subject to § 409A and Forfeitures. Any amount that acts as a substitute for amounts deferred under a nonqualified deferred compensation plan subject to § 409A constitutes a payment of deferred compensation under § 409A.[145]

Back-to-Back Deferred Compensation Arrangements (e.g. for Hedge Fund Managers).[146] Where a company is both a service provider and a service recipient, e.g., a hedge fund manager, with a

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Regarding clause (ii) above, ABA JCEB Q&As for IRS (2010) Q&A 24 provides that the company must terminate and liquidate all plans that would be aggregated with the terminated plan if the same hypothetical service provider had amounts deferred under every plan maintained by the company, included all entities treated as a single company.

143 Treas. Reg. § 1.409A-3(j)(4)(xiii) [pg. 381].

144 Preamble to Final Regulations, pg. 163.

The ABA JCEB Q&As for IRS (2008) Q&A 27 states that a typical mitigation clause (e.g., If executive is employed during the severance period, the severance is reduced by salary paid by new employer) would be permitted under § 409A because it is a forfeiture, rather than an offset, which is permissible under § 409A. The future employer does not owe the employee deferred compensation, so the employee will have a loss of the deferred compensation, and it is not going to change the time and form of payment, so it is treated as a forfeiture.

In case of reduction of amount of payment (e.g., severance in change in control agreement) by an existing obligation (e.g., company severance plan), this should not be an impermissible offset because it is not an offset by an amount the employee owes the employer, but is rather an agreement by the employee to receive less severance under the change in control agreement than his would otherwise have. This is similar to the above JCEB Q&A.

145 Treas. Reg. § 1.409A-3(f).

A forfeiture or voluntary relinquishment of an amount of deferred compensation will not be treated as a payment of the compensation, but there is no forfeiture or voluntary relinquishment if an amount paid is really just a substitution for the forfeited amount. Id.

Where the payment results in a reduction or offset of deferred compensation, the payment is a substitute for the deferred compensation. Id.

See IRS Chief Counsel Memo. 200935029 (8/28/09) (salary advances that can be offset by deferred compensation may be treated as a substitution of the deferred compensation and is not permitted under § 409A).

back-to-back fee deferral arrangement between the hedge fund and investment management company and a parallel deferred compensation arrangement between the manager and its employees is permitted under the regulations, so long as each deferred compensation arrangement complies with Code § 409A (regardless of whether the plan is actually subject to § 409A), and the deferred compensation arrangement between the hedge fund and investment manager provides for payments at the same time and form as the employee arrangement providing for payment on a 409A payment event.[147]

C. Options, SARs, Restricted Stock, RSUs and Partnership Interests.

Non-Applicability to FMV Options and SARs Without Deferral Feature. A nonqualified stock option does not provide for a deferral of compensation if: (i) the exercise price may not be less than the fair market value of the stock on the date of grant,[148] (ii) the number of shares subject to the option is fixed at grant, and (iii) the option does not include any deferral feature other than the deferral of income until exercise, disposition or vesting (i.e., the tax is not deferred beyond the exercise date).[149]

A stock appreciation right is not considered a deferral of compensation if the exercise price may not be less than the fair market value on the date of grant and the SAR does not include any deferral feature other than the deferral of income until exercise.[150] This exception applies regardless of

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146 See above, that payment schedules determined by timing of payments received by the employer would meet the requirements of a specified date or fixed schedule if the payments to the employer are routine bona fide payments, the employee does not have control of the employer or the payor of such payments, the payment schedule provides objective and nondiscretionary methods for identifying the payments to the employer from which the amount paid to the employee is determined, the payment schedule provides objective and nondiscretionary schedules for payments to the employee, and the payments to the employer result from sales of a type that employers in that trade or business make. Treas. Reg. § 1.409A-3(i)(1)(iii) [pg. 345].

147 Treas. Reg. § 1.409A-3(i)(6) [pg. 367]. This arrangement, in which the payment from the ultimate service recipient to the intermediate service recipient is based on the timing of payments under the § 409A compliant plan from the intermediate service recipient to the service provider is referred to as a forward back-to-back arrangement. The regulations do not currently provide relief for reverse back-to-back arrangements where the payment to the service provider is based on the timing of payments under a § 409A compliant arrangement from the ultimate service recipient to the intermediate service recipient. See Preamble to Final Regulations.

148 It is not clear if this requirement must be stated in the stock plan.

149 Treas. Reg. § 1.409A-1(b)(5)(i)(A) [pg. 209].

The grant date of an option would presumably be the date the grantee obtains a legally binding right to the stock right.

Where options are granted subject to subsequent shareholder approval, it is not clear what the date of grant is, although by analogy the ISO regulations treat the initial date as the grant date.

If options fails to meet the requirements of Treas. Reg. § 1.409A-1(b)(5)(i)(A) [pg. 209], it would appear that only the options of the optionee on that date are subject to § 409A and not all the options under the plan.

150 Treas. Reg. § 1.409A-1(b)(5)(i)(B) [pg. 209].

whether the SAR is settled in cash or stock, and regardless of whether the SAR is for nonpublic or public stock.[151]

Must be Stock of Service Recipient or Affiliate. The option or SAR must be with respect to stock of the employer (the service recipient), or controlled group member as discussed below.[152] Service recipient stock is common stock under § 305 of the Code, and can be common stock with a liquidation preference but not with other types of preferences, and not preferred stock.[153] The stock can be public or private, and under Final Regulations any class of common stock may be used even if another class of common stock has a higher aggregate value. ADRs and mutual company units may serve as recipient stock.[154] Service recipient stock can be stock of the actual employer or of the ultimate parent or any other higher-tier corporation where there is a 50% controlling interest in the corporate chain (or even a 20% controlling interest if the use of such stock is based on legitimate business criteria).[155]

Fair Market Value. For purposes of the stock option and SAR exceptions, fair market value for publicly traded stock can be based on the last sale before or first sale after the grant, closing price on the previous trading day, the arithmetic mean of the high and low prices on the trading day before the date of grant, or any other reasonable method.[156] For nonpublic traded stock, fair market value may be determined through application of a reasonable valuation method with various factors to be considered, as set forth in the regulations.[157] This will necessitate setting a legitimate fair market value even if, e.g., it is a startup company.

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151 As originally proposed in Notice 2005-1, Q&A 4(d)(iv), there would only be an exemption from § 409A for SARs if the SARs are for publicly traded stock and can be settled only for stock. However the proposed and Final Regulations have broadened this exemption and treat SARs like options.

152 Treas. Reg. § 1.409A-1(b)(5)(i)(C) [pg. 210].

153 Treas. Reg. § 1.409A-1(b)(5)(iii)(A) [pg. 213].

154 Treas. Reg. § 1.409A-1(b)(5)(iii)(B)&(C) [pg. 213 & 214].

155 Treas. Reg. § 1.409A-1(b)(5)(iii)(E)(1) [pg. 215]. However, stock in a corporation the primary purpose of which is to serve as an investment vehicle in other entities is not service recipient stock. Treas. Reg. § 1.409A-1(b)(5)(iii)(E)(2) [pg. 216]. Regarding corporate structure or transactions, a principal purpose of which is to avoid application of § 409A, their stock will not be considered service recipient stock. Treas. Reg. § 1.409A-1(b)(5)(iii)(E)(3) [pg. 217]. There are also special rules for substitutions and assumptions by reason of a corporate transaction. Treas. Reg. § 1.409B-1(b)(4) [pg. 217].

156 Treas. Reg. § 1.409A-1(b)(5)(iv)(A) [pg. 218]. The determination of fair market value for publicly traded stock can also be determined using the average selling price in specified period within 30 days of grant, as long as the program under which the stock right is granted must irrevocably state the commitment to grant the stock right. Id.

157 Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(1) [pg. 219]. A valuation of stock based upon a reasonable application of a reasonable valuation method is treated as reflecting the fair market value of the stock. It is not necessary that a taxpayer demonstrate that the value was determined by an independent appraiser. Id. The factors to be considered in determining the fair market value of the stock include consideration of any recent equity sales made by the corporation in arm's-length transactions. Id.

In the case of a stock right issued with respect to stock that was not publicly traded at the time the right was issued, but becomes publicly traded before the right is exercised, the stock value for purposes of calculating the payment amount (for SARs) or the buyback amount (in the case of a stock option where the underlying stock is

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Dividend Equivalents for Options or SARs. The right, with respect to the dividends accrued on the stock underlying the options or SARs, to be paid out on exercise (dividend equivalents) may not be made without jeopardizing the exemption for the options or SARs from § 409A, because it constitutes an offset to the option exercise price or increase in amount payable under the SAR.[158]

Exemption for ISOs or 423 Options . The grant of a Code § 422 incentive stock option or option under a Code § 423 employee stock purchase plan is not considered a deferral of compensation.[159]

See discussion below regarding grandfather for options granted by 10/3/04 and exercisable by 12/31/04, and regarding transition rule for substitutions of discounted options/SARs with nondiscounted options/SARs in 2005 or 2006.

Modification by Reduction in Exercise Price is New Option. In transactions in which new options are substituted for old options and the exercise price is below current fair market value, such exchanges would only be allowed if the substituted options were not considered a regrant, as will be discussed further below. Regulations provide that a modification of the terms of an option is considered the grant of a new option, with "modification" defined as a change in the terms of the option that may provide the optionee with a direct or indirect reduction in exercise price, and if the exercise price is below

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subject to a buyback agreement) must be based upon the rules governing stock that is publicly traded. This does not mean, however, that the initial exercise price determined under the rules governing stock that is not publicly traded must be reset. Preamble to Final Regulations, 72 Fed. Reg. at 19241 [pg. 33].

The Final Regulations adopt a presumption in specified circumstances that, for purposes of 409A, a valuation of stock reflects the fair market value of the stock, rebuttable only by a showing that the valuation is grossly unreasonable. The presumption applies where the valuation is based upon an independent appraisal, a generally applicable repurchase formula that would be treated as fair market value under section 83, or, in the case of illiquid stock of a start-up corporation, a valuation by a qualified individual or individuals applied at a time that the corporation did not otherwise anticipate a change in control event or public offering of the stock. Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(2) [pg. 221].

IRS Notice 2006-4 provides that for stock options and SARs issued but not vested before January 1, 2005 the fair market value determination will be made in accordance with the ISO rules at Treas. Reg. § 1.422-2(e)(2) (which generally deems the exercise price to be fair market value if it can be demonstrated that the issuer attempted in good faith to set exercise price at fair market value), and with respect to options and SARs issued after 2004 but before the effective date of Final Regulations, the notice reiterates the standard set in Notice 2005-1 Q&A 4(d)(ii) that the determination of fair market value may be made using any reasonable valuation method.

[158] Treas. Reg. § 1.409A-1(b)(5)(i)(E) [pg. 211]. A right to dividends not conditioned on the exercise will not be considered a reduction in the exercise price. Id. IRS officials have stated that currently payable dividend equivalents which terminate on option exercise are also considered contingent on the option expense (because they terminate at that point), and cannot be granted under the 409A exemption for options. However, dividend equivalents that are always immediately payable (or payable on option vesting) and do not expire on exercise should be okay.

[159] Treas. Reg. § 1.409A-1(b)(5)(ii) [pg. 212].

Note that in order to avoid § 409A, if there is any risk of disqualification of the ISO, care should be taken that the general option exceptions for stock options can be utilized.

fair market value at the time of the modification, it will be subject to § 409A.[160] The same applies to other stock rights. Modification does not include change in the terms of the option to shorten the period during which the option is exercisable or to provide for cashless exercise (or net-settled options).[161] A repricing at current fair market value would not subject the option to § 409A, because the regrant would not be considered a discounted option.[162] A cashout of options (e.g., in a transaction) that otherwise meets the exemption from § 409A would not be a problem because there is no modification of the option. It is not a modification to: (i) accelerate or delay vesting of an option which is not otherwise subject to § 409A;[163] (ii) substitute an option in a corporate transaction if requirements of Code § 424 are met or the ratio of exercise price to their market value after the transaction is not greater than the ratio before the transaction;[164] (iii) adjust the shares subject to the option by reason of stock split or stock dividend; [165] or (iv) in certain other cases.

Extension Allowed Only if Not Extended Beyond Earlier of Original Term or 10 Years From Grant. An extension is treated as the option having an additional deferral feature from the date of grant, and therefore the option would be subject to § 409A even if the exercise price is not below fair market value.[166] Extension means granting additional time in which to exercise the option, unless it meets the original term/10 year exception.[167] Under the original term/10 year exception set forth in the Final Regulations, it is not an extension if the exercise period of the stock right is extended to no later than the earlier of (i) the latest date upon which the stock right could have expired by its original terms or (ii) the 10th anniversary of the original date of grant of the stock right.[168]

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[160] Treas. Reg. § 1.409A-1(b)(5)(v)(A) & (B) [pg. 224].

[161] Treas. Reg. § 1.409A-1(b)(5)(v)(B) [pg. 224]. Acceleration of vesting of an option should also not be considered a modification.

[162] There may be some concern that the repricing could be treated as merely an extension of the term, which, as discussed below, could be a problem even if it is repriced at current fair market value. However, the more reasonable view is that it is treated as a new grant and is not an extension. There may be other issues, such as Schedule TO requirement for tender offer, particularly if the repricing needs participant consent.

[163] Treas. Reg. § 1.409A-1(b)(5)(v)(E) [pg. 230].

[164] Treas. Reg. § 1.409A-1(b)(5)(v)(D) [pg. 228]. For Code § 424 purposes, the ratio test requires that the aggregate ratio of exercise price to fair market value in the new option is the same as under the old option. However, for § 409A purposes the regulation allows one to merely test that the ratio of the exercise price to fair market value is not greater (but can be less) after the transaction than before the transaction.

[165] Treas. Reg. § 1.409A-1(b)(5)(v)(G) & (H) [pg. 231].

[166] Treas. Reg. § 1.409A-1(b)(5)(v)(A) [pg. 224]. Although an additional deferral feature or an extension is also a modification, it would be treated as also having an additional deferral feature and therefore subject to § 409A even if the exercise price at that time is not below fair market value.

[167] Treas. Reg. § 1.409A-1(b)(5)(v)(C) [pg. 225].

A rollover of options to buyer options should not be an extension merely because the original option would have terminated on termination and new options continue for the remainder of the term. (See Treas. Reg § 1.409A(b)(v)(B) that is not a modification to exercise discretion under the plan to transfer the rights.)

[168] Treas. Reg. § 1.409A-1(b)(5)(v)(C) [pg. 225].

Consequences of Stock Options or SARs Being Subject to § 409A. If options (or SARs) are discounted, or have a deferral feature, or otherwise become subject to § 409A, presumably the terms would not comply with § 409A because there is no fixed payment date etc., and this would cause the optionee to be taxed at the time the options become vested rather than at the date of exercise, and would also cause the optionee to have a 20% additional tax in addition to the income tax, employment tax, and interest.[169] The employer may have a withholding obligation for the income and employment tax.

Solution Where Options or SARs are Subject to § 409A. It would be very difficult to have an option that is subject to § 409A (e.g., a discounted option) comply with § 409A. A solution is to amend the option so that it can only be exercised on a fixed date in the future (can even be a specified year) or one of the permitted distribution events of § 409A(a)(2) (such as early acceleration on change in control).[170]

Restricted Stock Not Subject to § 409A. The receipt of restricted stock and other restricted property is not considered a deferral of compensation under § 409A even though it is not currently taxable under § 83, because there has already been a transfer of property even though not yet vested.[171]

RSUs Subject to § 409A if Shares Not Delivered at (or Within Short-Term Period After) Vesting. Restricted stock units, also known as phantom stock, and other deferred delivery stock would be subject to § 409A, unless they are settled immediately when the units vest or within the 2 ½-month short-term deferral period. Alternatively, the agreement could provide that the participant must be actively employed at the company at the settlement date in order to receive such award, so that the legally binding vested right is delayed until the payment date.[172]

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169 There may also be tax on the annual market-to-market increase in value.

170 A solution that existed prior to 2008, was to convert the option to a non-discounted option and make up the difference with a payment that would not vest until a later year.

171 Treas. Reg. § 1.409A-1(b)(6)(i) [pg. 236]. Thus, there is no deferral of compensation where stock is not currently taxable under § 83 because it is currently subject to a substantial risk of forfeiture (as defined in § 83) or is only taxable due to a § 83(b) election. Id.

172 A plan where the employee obtains a legally binding right to receive property in a future year may provide for the deferral of compensation, unless it is not vested until payment (or within the taxable year ending within 2 1/2 months before payment). Treas. Reg. § 1.409A-1(b)(6)(ii) [pg. 237].

Since RSUs that pay out on vesting are not subject to § 409A, accelerated vesting on some type of change in control (even if not satisfying the § 409A definition) should not affect its exclusion from § 409A.

Where the RSUs vest on termination without cause or quit for good reason, and the good reason does not comply with the 409A definition, the RSUs would not satisfy 409A even if payable as soon as vest because considered not subject to substantial risk of forfeiture at earlier time when good reason could be triggered.

Where an award provides for a vested right to dividend equivalents, this may be a short-term deferral if the uncertainty of payment of dividends is a substantial risk of forfeiture.

See ABA JCEB Q&As for IRS (2008) Q&A 35 that even with regard to RSUs that are deferred compensation under § 409A, dividend equivalents with respect to those RSUs would be short-term deferrals if, e.g., they provide that the employee will be paid the dividend equivalents on each dividend payment date but only if the employee is employed on the dividend payment date.

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Sometimes it may not be practical to structure the RSUs as short-term deferrals. For example, there may be a desire to allow for a deferral of the vested RSUs, or to delay payment until termination. If the RSUs are subject to § 409A then they will need good definitions for payout events such as a § 409A definition for separation from service, a specified date/fixed schedule or a § 409A change in control (assuming the amount is payable or has a toggle on the change in control alone), and for specified employees payouts on termination will be delayed by six months. The payout would be specified as separation from service or a date tied to separation from service, or the later of x date or separation from employment. Also, the committee cannot have a choice as to what to do with RSUs in a change in control.

Partnership Interests. Notice 2005-1 provides that the taxpayer may treat the grant of partnership interests or option to purchase partnership interests in the same manner as the grant of stock.[173] The same would be true of an LLC taxed as a partnership.

D. Application to SERPs.

Changes in Benefits of SERPs Resulting from Changes in Benefits Under Qualified Plan is Permissible. The regulations provide guidance regarding supplemental executive retirement plans ("SERPs") and other nonqualified plans linked to qualified plans (or broad-based foreign retirement plans), for example to replace the benefits that would have been provided under the qualified plan absent §§ 415, 401(a)(17), 402(g) and other limits in the Code.[174] With respect to the benefits provided under a nonqualified plan that results directly from the qualified plan, the amendment of the qualified plan to increase or decrease such benefits or to stop future accruals under the qualified plan, is not treated as a deferral election or an acceleration of payment under the nonqualified deferred compensation plan, provided, that such action does not otherwise result in a change in time or form of payment under the

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According to IRS officials, dividend equivalents on options are contingent on option exercise and would be an offset causing the options to be subject to § 409A. See Treas. Reg. § 1.409A-1(b)(5)(i)(E) [pg. 211].

173 Notice 2005-1, Q&A 7. A profits interest that would not be included in income (see Rev. Proc. 93-27 and Rev. Proc. 2001-43) would also not be a deferral under § 409A. Id. The Preamble to the 2005 Proposed Regulations reserves treatment on partnership arrangements and states that one can rely on Notice 2005-1, Q&A 7 until further guidance is issued. The Final Regulations do not address partnership interests.

See also, Swartz, "Section 83(b), Section 409A and Subchapter K," PLI Tax Law & Practice, Oct.-Dec. 2008.

174 Where amounts deferred under a nonqualified deferred compensation plan are linked to the benefits under a qualified plan, certain participant actions taken with respect to the benefits accrued under the qualified plan may affect the amounts deferred under the nonqualified deferred compensation plan.

Where the amounts deferred under the nonqualified deferred compensation plan increase, the issue in Treas. Reg. § 1.409A-2(a)(9) [pg. 304] is whether the action taken with respect to the benefits accrued under the qualified plan constitutes a deferral election. Where the amounts deferred under the nonqualified deferred compensation plan decrease, the issue in Treas. Reg. § 1.409A-3(j)(5) [pg. 382] is whether the action taken with respect to the benefits accrued under the qualified plan constitutes an impermissible acceleration of a payment under the nonqualified deferred compensation plan.

nonqualified plan.[175] The qualified plan must be sponsored by the service recipient or its controlled group affiliate under Code § 414(b) or (c).[176]

Changes to a subsidized ancillary benefit under a qualified plan, or a participant election with respect to such benefit can be made even if they result in an increase or decrease in amounts deferred under the nonqualified plan.[177]

Changes in 401(k) Elections Affecting SERPs. With respect to nonqualified deferred compensation plans linked to 401(k) plans, an employee's action or inaction under the qualified plan, including adjustments to elective deferrals or other pre-tax contributions to the qualified plan, will not be treated as a deferral election or an acceleration of payment under the linked nonqualified plan, provided that the actions under the qualified plan do not result in an increase in the amounts deferred under all nonqualified deferred compensation plans in which the employee participates in excess of the maximum elective contribution that could have been made under the 401(k) plan under § 402(g) ($16,500 in 2010), and provided further that matching contributions under a qualified plan that affect the nonqualified plan do not result in an increase in deferred amounts under the nonqualified plan in excess of the matching contributions that could have been made with regard to the salary deferrals.[178] This relief would help with the § 402(g) limit only if the deferral under the nonqualified plan does not exceed the $16,500 § 402(g) limit.

More About Deferral Elections and SERPs. Employee deferral elections or accelerations of payment made under the SERP itself will be treated as a deferral election or an acceleration of a payment under the nonqualified plan and must meet the § 409A requirements. (See below regarding transition relief for linked plan elections by 12/31/08 even if they do not meet the above rules.)

Cannot Use Qualified Plan Forms of Distribution for SERP. Note that for linked plans where the distribution form for the nonqualified plans follows the qualified plan distribution form election, such elections would likely fail § 409A. Thus, the SERP must separately provide for elections with regards to: participation (if participation is optional), deferrals (for 401(k) SERPs), and distribution forms (both as to time and form of payment). The forms elected under the qualified plan will not suffice.

The beneficiary designation does not need to be de-linked from the qualified plan because it is not otherwise changing the time and form of payment.[179]

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175 Treas. Reg. §§ 1.409A-2(a)(9) [pg. 304] & 1.409A-3(j)(5) [pg. 382].

176 Treas. Reg. § 409A-3(j)(5) [pg. 382]. Definition of service recipient affiliate in Treas. Reg. § 1.409A-1(g) uses Code §§ 414(b) and (c) affiliate definition, as stated above.

177 Id.

178 Treas. Reg. § 1.409A-3(j)(5) [pgs. 383-384]. The Preamble to the Proposed Regulations notes that this is intended to address common arrangements whereby the amounts deferred under the nonqualified deferred compensation plan are linked to amounts deferred under a 401(k) arrangement, but only to the extent the amount of affected deferrals under the nonqualified deferred compensation plan does not exceed the maximum amount that ever could have been electively deferred under the qualified plan.

179 See similarly, Treas. Reg. § 1.409A-2(b)(3) that a change in a beneficiary will not be treated as a change in the time and form of payment, if the change in the time of payment stems solely from the different life expectancy of the new beneficiary.

Note that 401(k) wrap plans[180] would generally not be permissible under § 409A because of their link to 401(k) distribution options.

Distribution Forms Under SERP. The distribution forms available under the SERP can follow the distribution forms available under the underlying qualified plan. However, they must be proper distribution events under Code § 409A(a)(2)(A). For example, provision for payment on retirement must state that it is also a "separation from service" under § 409A, and must also provide for six-month delay for specified employees. Any distributions on change in control must use a permitted definition of change in control under § 409A.[181]

Note that some SERPs may provide for suspension of benefits in the event of re-employment following benefit commencement. This would appear to be impermissible under Code § 409A.

E. Application to Bonus Plans.

If a bonus plan is discretionary there is no legally binding right until payment is made and therefore there is no deferral.[182] Even negative discretion to reduce or eliminate the bonus awards will cause there to be no legally binding right and no § 409A deferral, unless the negative discretion is never used and lacks substantial significance, in which case there would be a legally binding right when the achievement of the performance goals are knowable.[183] For example, if a cash incentive plan has one year objective performance goals for 2008, and the committee will pay the bonus in 2009 once it certifies the goal (and negative discretion to cut back doesn't exist or is never used), the bonus would be viewed as having a legally binding right when the performance targets are knowable, which would be on Dec. 31, 2008, in which case to avoid § 409A deferral, the awards must be required to be paid by March 15, 2009 to fit within the short-term deferral exception.[184] Another alternative is for the plan to provide that the employee must be employed on the date of payment to receive the bonus, in which case there is no binding legal right until payment and therefore no § 409A deferral.

The main consequences of a bonus plan becoming subject to § 409A, where it is not a short-term deferral, are as follows: the bonus plan would need to provide specified payment dates; if there are accelerated payments upon separation from service, disability, death, change in control, etc., such distribution triggers would need to comply with the § 409A definitions; the deferral would have to be reported (Code Y in box 12 of Form W-2); and to the extent the bonus is payable on account of separation from service a six-month wait for specified employees would be required.

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180 A 401(k) wrap plan has employees electing to defer amounts first to a nonqualified deferred compensation arrangement and, to the extent they did not exceed the ADP or ACP limit for the plan year, they are automatically transferred to the 401 (k) plan.

181 Distribution on termination after disability would generally not need to have "disability" satisfy the Code § 409A, as long as it is not paid on disability alone. (This could raise a toggling issue is the forms of distribution are different). However, distribution on termination after disability would require the six-month wait for specified employees, because it is a payment on termination, as noted above.

182 See Treas. Reg. § 1.409A-1(b)(1) [pg. 201].

183 Id. See also, Treas. Reg. § 1.409A-1(b)(4)(iii), Examples [pg. 207].

184 It does not suffice to say that amount will be payable "promptly."

If an employment agreement provides that upon a "quit for good reason" the employee is entitled to a pro-rata portion of the bonus and there is no good 409A good reason definition, it would have the same issue that severance has, namely, that even if payable within 2-1/2 months after the year, it would still be a deferral of compensation because the employee could quit at any time and receive the pro-rata bonus, and thus there would be a legally binding vested right even prior to termination, as is the case for severance. Furthermore, even if the pro-rata bonus is payable on any termination and not just a quit for good reason, there would also be a 409A deferral of compensation because there was a legally binding right to quit at any time and receive pro-rata bonus, and thus there was a legally binding vested right even prior to termination.[185] One alternative is to have the pro-rata bonus be paid only at the time it is ordinarily paid to other employees (based on the achieved targets at that time).[186] Otherwise it would be subject to 409A and would require: (i) a valid 409A definition of termination because pro-rata portion is payable on terminations, (ii) a fixed payment date or schedule under 409A because bonus is payable on such dates if there is no earlier termination, and (iii) a six month delay if becomes payable on termination and the employer is a public company.

F. Application to Severance Arrangements and Employment Agreements.

Severance plans are not excluded from the definition of deferred compensation plan.[187]

Severance Plans at the Discretion of the Employer are Excluded Since There is No Legally Binding Right. Severance plans that can be reduced or terminated by the employer are discretionary and the employee does not have a legally binding right. Therefore, there is no deferral of compensation under § 409A as discussed above.[188] However, once an individual separation agreement is signed providing for the severance over a period of time this may require a six-month wait for key employees. Individual employment agreements or union plans that cannot be unilaterally amended could also be subject to § 409A.

Exception if Payout Only on Involuntary Termination (e.g., Termination Without Cause) or Within 2 ½ Months After the Year of Such Termination. Where severance arrangements only pay out

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185 Counter arguments to this are (i) the employee may not be vested in the bonus standards (unless there are objective standards that relate to the company or the person are met); (ii) the bonus is not vested prior to termination because unless the employee works he will not have a vested right, and if he does work the payment would be within a short-term deferral period.

186 This would also solve any issues under Code § 162(m) relating to a 2007 private letter ruling and Revenue Ruling 2008-13, where the IRS reversed its position, and held that if a bonus or performance pay plan allows (in the plan or in a separate employment agreement) for the executive to receive the compensation even without meeting the performance targets upon termination without cause, quitting for good reason or, as stated in the revenue ruling, voluntary retirement, then the award for such executive would not be qualified performance-based compensation even if the targets are in fact me

187 Code § 409A(d)(1)(B) excludes certain welfare plans but does not exclude severance plans.

Separation pay refers to compensation conditioned upon a separation from service (including death or Disability) and not to compensation the employee could receive without separating from service (such as an amount also payable upon a change in control, an unforeseeable emergency, or on a date certain). Treas. Reg. § 1.409A-1(b)(9) [pg. 241]. For example, the right to a gross-up payment for taxes payable due to the application of § 280G will constitute separation pay only if a separation from service is required to obtain the payment. Preamble to Final Regulations.

188 Treas. Reg. § 1.409A-1(b)(1) [pg. 201].

on an involuntary termination, e.g., on termination without cause, this would cause the payment to be a nonvested right (i.e., subject to a substantial risk of forfeiture) until termination, and from the point of termination when there is a legally binding vested right it would be a short-term deferral exempt from § 409A if the severance is paid within 2 ½ months after the year vested.[189] Therefore, it is important to draft change in control and employment agreements so that severance will be fully paid within 2 ½ months after the end of the taxable year (of the employer or the employee), or alternatively that it meet the two-times-pay two-year exception below.

Test For When Quit For Good Reason is Considered Involuntary Separation. Where severance is also payable if the employee quits for good reason, the severance will be treated as payable only on an involuntary termination where the good reason condition is such that the separation from service is effectively an involuntary separation from service (a constructive discharge).[190] If the good reason trigger is viewed as a voluntary termination, this would be considered a vested right even prior to termination, and therefore the severance would not meet the 2 ½ month short-term deferral exception and the severance would be subject to the requirements of § 409A, which would require a six-month delay for key employees of public companies, as discussed above. Likewise, if there is a right to walk for any reason (even if only after a change in control), this would cause there to be a voluntary termination and therefore not meet the short-term deferral exception.[191]

For good reason to be treated as an involuntary separation, the avoidance of § 409A must not be a purpose of the good reason trigger.[192] In addition, such good reason condition must be triggered by action taken by the employer resulting in a material negative change in the employment relationship, such as a material negative change in the duties to be performed, the conditions under which such duties are to be performed, or the compensation to be received.[193] Additional factors that may be relevant are: the extent to which the payments upon quit for good reason are the same as payments upon a termination by the employer, and whether the employee is required to give the employer notice of the existence of the good reason condition and a reasonable opportunity to remedy the condition.[194]

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[189] An involuntary separation from service is a separation due to independent exercise of unilateral authority of the employer to terminate the employee (other than by the employee's request). Treas. Reg. § 1.409A-1(n)(1) [pg. 290].

[190] Treas. Reg. § 1.409A-1(n)(2)(i) [pg. 291].

[191] Even if the right to walk is only within a window of, e.g., the 13th month, there would not be a good 409A good reason (even with respect to payments made prior to the 13th month) and the 6 month delay would be required (unless in all instances payment will be made within a short term deferral period).

The requirements to sign a release for severance will likely not make the payment into a nonvested right. Note that even if the good reason is voluntary, if there is a double trigger with change in control there would presumably be no vesting prior to the change in control.

[192] Treas. Reg. § 1.409A-1(n)(2)(i) [pg. 291].

[193] A right by the employee to walk after a change in control would not be a good 409A good reason.

[194] Id.

The regulations provide that an involuntary separation from service may include the employer's failure to renew a contract at the time it expires, provided that the employee is willing and able to execute a new contract

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Safe Harbor Good Reason. The regulations provide a safe harbor under which a provision for a payment upon a voluntary separation for good reason will be treated for purposes of §409A as an actual involuntary separation. These conditions include that: (i) the amount be payable only if the employee separates from service within two years following the good reason trigger, (ii) the payment upon a quit for good reason be identical to the payment upon an involuntary separation (by a termination without cause), and (iii) the employee must be required to provide notice of the existence of the good reason condition within 90 days, and the employer must be provided at least 30 days during which it may remedy the good reason condition.[195] A good reason condition may consist of one or more of the following conditions: (1) a material diminution in the employee's base compensation; (2) a material diminution in the employee's authority, duties, or responsibilities; (3) a material diminution in the authority, duties, or responsibilities of the supervisor to whom the employee reports, including a requirement that an employee report to a corporate officer of the employer instead of reporting directly to the board of directors; (4) a material diminution in the budget over which the employee retains authority; (5) a material change in the geographic location at which the employee must perform the services; or (6) any other action or inaction that constitutes a material breach of the terms of an applicable employment agreement.[196]

Note that the failure to have successor assume the plan is not a good 409A good reason. However, it should be permissible to provide in a covenant elsewhere in agreement that employer will obtain consent of the successor to assume the contract, and then it may be a material breach of the agreement which is covered as an unforeseeable emergency.

Notice 2007-78 § IV.A provides that an amendment to an existing "good reason" definition made prior to December 31, 2007 (or December 31, 2008 under Notice 2007-86 § 4), for amounts that are not yet vested will be valid, and will not be considered a prohibited extension of a forfeiture condition. Likewise if a good reason provision is subject to a substantial risk of forfeiture (e.g. it is a double trigger based in part on change in control which has not yet occurred), then it can be converted to a safe harbor good reason in 2008.[197]

Severance cannot be delayed until completion of noncompete (unless it meets short term deferrals) because noncompetes are not good 409A substantial risks of forfeiture.[198]

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providing terms and conditions substantially similar to those in the expiring contract and to continue providing such services. Treas. Reg. 1.409A-1(n)(2)(i) [pgs. 290-291].

195 Treas. Reg. § 1.409A-1(n)(2)(ii) [pg. 292].

196 Id.

It is recommended to generally adhere to the safe harbor as a precaution for the executive. Some variations though that is not significantly different (e.g., material diminution in base and bonus) would probably not raise IRS objections.

197 Notice 2007-78 § IV A. (and Notice 2007-86 § 4). See also, Hogans & Collins, Internal Revenue Code Section 409A: Ten Traps for the Unwary, § IV, BNA Pension & Benefits Daily (1/8/08).

198 See also, Preamble to Final Regulations that payment for a noncompetition agreement could be subject to § 409A, since a noncompete does not create a substantial risk of forfeiture, and a legally binding right obtained in

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Notice 2007-78 also provides that until further guidance is issued, an extension of an employment agreement or entering into a new employment agreement will not be considered a substitution for rights to deferred compensation, as long as the previous right to the deferred compensation was payable only on an involuntary termination.

Severance Conditioned on Executing Release of Claims. When payment of severance is conditioned on the employee's signing a release of claims (e.g., an ADEA release) in the form attached to the agreement,[199] and the employee can sign the release at any time, this could cause the severance arrangement to fail to be a short-term deferral or not have a fixed payment date, according to IRS officials.[200] One solution that practitioners have used is to provide a fixed deadline in which time to execute the release, e.g., the release must be executed and not revoked by the 60th day or 90th day following termination, and the terms of the release would be agreed upon in advance. This way, the ADEA 21-day period to consider the release, or the 45-day period in connection with an exit incentive program or other employment termination program, and the 7 days to revoke can be satisfied before the expiration of that period, and the payment is fixed to within 90 days following termination. In addition, in order to avoid an employee being able to control the year of payment (which is impermissible under Treas. Reg. § 1.409A-3(b)) a provision would also need to be added that if the 60 or 90 day period begins in one taxable year and ends in the next taxable year the payment will automatically be pushed to the next taxable year.

The IRS had indicated informally and in Notice 2010-6, however, that such a solution may not work, because there would be an impermissible toggle by being able to have a different pay option depending on whether the employee terminates before or after November 1 (and a specific date in each year in the IRS officials' view would not fit within the "toggle" rule exception of § 1.409A-3(c)). The solution the IRS suggested is to require is that regardless of whether the release is executed right away, the severance payment will only be made 60 days after termination, provided an irrevocable release is in place by then.[201] This solution is supported by Notice 2010-6 § VI.B, which provides a documentary correction that if payment is conditioned on the employee executing a release, correction can be made before the permissible payment event occurs by removing the ability of the employee to delay or accelerate the timing of the payment as a result of his or her actions, and fixing the payment date at 60 or 90 days after the payment event.

The IRS has retreated somewhat from their position, and has determined that the first solution – to set a 60 day or 90 day deadline for executing the release and to push the payment date to the next year if this period begins in one calendar year and ends in the next year – would also work. This

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one year to a payment in a subsequent year in connection with the noncompete agreement generally would constitute deferred compensation. 72 Fed. Reg. at 19236 [pg. 11].

199 Releases are often attached to employment or change of control agreements so that the company cannot hold up the severance for an overly restrictive release. Other times the agreement may say that severance is subject to customary release.

200 The release for continued health coverage would generally not be an issue, as long as they do not extend beyond the COBRA period.

201 Continued health coverage is generally not subject to 409A, and therefore the timing of payment/reimbursement for it is not an issue. So even if the employer wants to condition health benefits on executing release, one wouldn't have to wait the full 60 days, just until the release is executed, and then maybe you could even have the health benefits made retroactive (depending how agreement is worded).

position is set forth in Notice 2010-80 that payment of severance can be set as not longer than 60 or 90 days following the termination (the permissible payment event), provided that if such 60 or 90 day period begins in the employee's first taxable year and extends into the employee's second taxable year, the payment must be made in the second taxable year (or alternatively the payment can be set for the last day of the period as per the 2010-6 method).[202]

Note that much of the above requirements only apply if the severance arrangement is subject to 409A, but if the severance can be paid within the short term deferral period (e.g., has good 409A good reason definition) or within the two years two times pay exception for involuntary terminations, this would avoid application of 409A and therefore it would not be subject to the toggle rule relating to 409A payment events or the straddling of two years. The release would have a fixed deadline that must be executed and become irrevocable within e.g., 60 days, and the severance would have to be paid in all events no later than 2 ½ months (to ensure that it is a short-term deferral), or within two years if relying on that exception.

Treatment of Involuntary Severance Plan as a Separate Plan. For purposes of the plan aggregation rules, discussed above, the regulations provide for separate treatment of plans providing for separation pay due solely to an involuntary separation from service or participation in a window program. This exception is not intended to apply where the amounts may also become payable for some other reason, even where such payments actually are made due to an involuntary separation from service. Accordingly, any amount that would be paid as a result of a voluntary separation from service (other than good reason if treated as involuntary) will not be included in this category.[203]

Exception for Involuntary Severance or Early Retirement Programs if Separation Pay Does Not Exceed Two Times Lesser of Pay or 401(a)(17) Amount and Paid by Second Year Following Separation. Severance plans that pay upon an involuntary separation from service or pursuant to an early retirement window program are exempt from § 409A if the separation pay does not exceed two times the employee's pay or two times the Code § 401(a)(17) limit ($245,000 in 2010), and the severance is paid by the end of the second calendar year following the year of separation.[204] This exception will not help for voluntary termination, e.g. if there is not a good 409A good reason definition, but it will help for involuntary termination, so that it need not be paid within 2 ½ months after the taxable year of vesting if the above exception is met. If there is a quit for good reason trigger, it will still be involuntary termination if it is a good 409A good reason, as described above.[205] If there is payment on a non-compliant good reason or on a termination for any reason (even if only after a change in control) the requirements for an involuntary severance would not be met.

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[202] Notice 2010-80 § III.B modifying § VI.B.2 of Notice 2010-6.

[203] Treas. Reg. § 1.409A-1(c)(2)(i)(D) [pg. 252]. Preamble to Final Regulations.

[204] Treas. Reg. § 1.409A-1(b)(9)(iii) [pg. 244]. This exemption is similar to the safe harbor to treat severance plans as welfare plans under DOL Reg. § 2510.3-2(b).

There was a transition rule for severance plans adopted before Dec. 31, 2005 so that they could be terminated until the end of calendar year 2005, in order to terminate participation or cancel a deferral election. It also did not have to meet the requirements of § 409A for calendar year 2005, if it was a collectively bargained plan or covered no key employees. Notice 2005-1, Q&A 19(d). See further below.

[205] IRS officials have indicated that the two years/two times pay exception only applies to amounts payable solely on involuntary termination but not if, e.g., also payable on disability.

Note that the § 402(g) limit payment exception ($16,500 in 2010) discussed below can be added to the two times § 401(a)(17) amount ($490,000 in 2010).

See also above for general exception for discretionary plans that can be reduced or terminated by the employer. There is also an exception for collectively bargained severance plans.[206]

Exception from 409A for Reimbursement for Expenses, In-Kind Benefits and other Fringe Benefits Following Termination of Employment. As noted above, expense reimbursements will not meet the short-term deferral rule because a legally binding right arises when the right to reimbursement occurs (even prior to incurring the expense). There is a general rule that reimbursements of expenses, in-kind benefits, and medical reimbursements will be treated as if made at a specific date or fixed schedule if the reimbursement is made by the end of the calendar year following the year of expense and certain other requirements are met, as discussed above.[207] However, the six month delay for specified employees would still be applicable to such reimbursements. If the expense reimbursement payments are made on account of termination, there are more broad exceptions that entirely exempt from the payments from § 409A. Where plans provide for reimbursements (even if not otherwise excludible from gross income) for expenses that could be deducted as business expenses or reimbursement of reasonable moving expenses or reasonable outplacement expenses, and such expenses are directly related to a termination of the employee's services and incurred by an employee following a separation from service, such reimbursements are not subject to § 409A, provided that such reimbursements are available only for expenses incurred within the second taxable year of the employee following the separation from service (although reimbursement can occur until the third year).[208] Amounts that would be excludible from gross income would in any event be exempt from 409A.[209]

There is also an exception for severance providing for medical benefit reimbursements, provided they do not extend beyond the COBRA period.[210] It is arguable that the six-month delay could run concurrent with the COBRA period, thus avoiding the need for six-month delay even if § 409A would otherwise apply.[211] Note also that the medical reimbursement exception is only needed for medical plans that are taxable under IRC § 105 because they fail the nondiscrimination rules of § 105(h) where only senior executives receive the retiree health as part of severance (and discriminates

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206 Treas. Reg. § 1.409A-1(b)(9)(ii) [pg. 243].

207 Treas. Reg. § 1.409A-3(i)(1)(iv) [pg. 346].

208 Treas. Reg. § 1.409A-1(b)(9)(v) [pgs. 245-247], as amended in 72 Fed. Reg. 41620 (July 31, 2007) to remove a misleading comma. The same exception would apply to employer payment of premiums for a self-insured plan. ABA JCEB Q&As for IRS (2008) Q&A 26.

209 See, e.g., Treas.Reg. § 1.409A-1(b)(1) (third sentence): "A legally binding right to an amount that will be excluded from income when and if received does not constitute a deferral of compensation, unless the service provider has received the right in exchange for, or has the right to exchange the right for, an amount that will be includable in income [other than a cafeteria plan]." See also, Treas.Reg. § 1.409A-1(a)(5) [pg. 200] re nontaxable medical arrangements, and Treas.Reg. § 1.409A-1(b)(4)(B) [pg. 204] re short-term deferrals and receipt being when taxable, and Treas.Reg. § 1.409A-1(b)(6) [pg. 237] re no receipt if nonvested property is not taxable.

210 Treas. Reg. § 1.409A-1(b)(9)(v)(B) [pg. 246].

211 In addition, the medical reimbursement exception under Treas. Reg. § 1.409A-3(i)(1)(iv)(B) [pg. 347] may also apply.

in eligibility under § 105(h)).[212] Prior to the Patient Protection and Affordable Care Act of 2010, IRC § 105(h) only applied to self-insured plans. Under the Affordable Care Act, insured plans are now also subject to § 105(h) nondiscrimination rules except for grandfathered plans where the insured plans were in existence on March 23, 2010. (See discussion above regarding the Affordable Care Act provisions.) Thus, with regard to self-insured plans or new insured plans, the post-employment "benefits" (and not merely premiums) received only by the executives would be taxable to them. As an alternative, for self-insured or new insured plans the employer could increase the cash severance but not pay any COBRA or plan insurance premiums. The executive could purchase individual coverage which would not be a group health plan and would not be subject to nondiscrimination rules.

IRS officials have indicated that medical benefit reimbursements would include payment or reimbursement for medical (or COBRA) premiums or by providing the actual benefits.

The Final Regulations provide that in-kind benefits provided to the employee by the employer do not provide for a deferral of compensation if benefits must be provided by the end of the second year following the separation from service.[213]

See also above regarding requirements for expense reimbursements for an active employee and when they will be considered made at a fixed time or schedule.

The Final Regulations clarify that a right to a benefit that is excludible from income, for example, health coverage excludible under Code § 105 (provided it doesn't fail § 105(h)), will not be treated as a deferral of compensation for purposes of § 409A.[214]

Limited Payment Small Sum Cashout Exception. There is an exception for payments under a separation plan that do not defer amounts in excess of the Code § 402(g) limit (currently $16,500 in 2010).[215] This can be "stacked" with the $490,000 amount to allow deferrals of $506,500.

Stacking of Exemptions. The exemptions from 409A for separation pay plans may be used in combination (so-called "stacking"). The two times pay or 401(a)(17) amount exception, reimbursements for reasonable moving expenses and outplacement expenses, payments that do not exceed the limit on elective deferrals under § 402(g), payments during the short-term deferral period, etc., may all be excluded from coverage under § 409A due to application of several of the above exceptions at the same time.[216] For example, if a termination occurs on July 1, 2008, the amounts payable in the short-

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212 If the medical reimbursement arrangement is nontaxable it is entirely deductible from § 409A under Treas. Reg. § 1.409A-1(a)(5).

213 Treas. Reg. § 1.409A-1(b)(9)(v)(C) [pg. 246].

214 The Final Regulations extend the limited period during which taxable reimbursements of medical expenses (e.g. for discriminating self-insured plans) may be provided, to cover the period during which the employee would be entitled to COBRA continuation coverage if the employee elected such coverage and paid the applicable premiums. In addition, the Final Regulations contain several provisions governing reimbursement plans (Treas. Reg. § 1.409A-1(b)(9)(v) [pg. 245]) (including plans providing in-kind benefits) that constitute nonqualified deferred compensation plans for purposes of section 409A. Id.

215 Treas. Reg. § 1.409A-1(b)(9)(v)(D) [page 247]. There is a similar exemption in Treas. Reg. § 1.409A-3(j)(4)(v) [pg. 374] discussed above, regarding permissibility of acceleration of small sum cashouts.

216 Treas. Reg. § 1.409A-1(b)(9)(i) [pg. 241] and Preamble to Final Regulations, 72 Fed. Reg. at 19246 [pg. 55].

term deferral period through March 15, 2009 could be treated separately from the severance payable after the short-term deferral period, so that even if the total severance exceeds the two times the 401(a)(17) limit, the separate parts would each be separately exempt.[217] There would have to be a designation of the separate payments to bifurcate the stream of payments into a short-term deferral payment and a 409A two year two times pay amount.[218]

Indemnification and Legal Settlements. A plan that provides for indemnification of, or purchase of insurance policy for claims relating to the employee's work for the employer is not a deferral of compensation.[219]

Treasury Regulations exempt legal settlements resolving bona fide claims for wrongful termination, employment discrimination, the FLSA, or worker's compensation, even where the settlements are treated as compensation for Federal tax purposes.[220] However, the exception covers only rights arising from the bona fide claim, and is not intended to allow such settlements or awards to act as substitutes for, or to allow for the restructuring of, preexisting deferred compensation subject to section 409A.[221]

Consequences of Applicability of § 409A to Severance Arrangements. Where a severance arrangement is subject to § 409A, e.g., an arrangement that is nondiscretionary by the employer and is considered voluntary to the employee (for example, where there is a broad good reason condition that is not treated as involuntary), there would be the following § 409A consequences: (i) a six month delay would be required for key employees of public companies under § 409A(a)(2)(B);[222] (ii) distribution would have to be at a permitted 409A payment event under § 409A(a)(2)(A), such as a fixed time/fixed

[217] Another example: If severance is paid over three years, the payment must be delayed six months only to the extent that the payments over that period are not eligible for another exception, like the two times pay or 401(a)(17) exception, assuming that there is a good 409A good reason definition.

[218] Treas. Reg. § 1.409A-2(b)(2) [pg. 314] (a plan can designate installment payments to be treated as a series of separate payments). See also, Treas. Reg. § 1.409A-3(c) [pg. 333] that a single time and formal benefit must be designated for each payment event.

[219] Treas. Reg. § 1.409A-1(b)(10) [pg. 248]. Even if the repayment does not fall within this exception, it is permissible if reimbursement is made by the 15th day of the third month after the later of the employer or employee's taxable year in which loss was incurred. (Presumably indemnification would be treated like compensation rather than like reimbursements.)

[220] Treas. Reg. §1.409A-1(b)(11) [pg. 248] This is true even where the settlements or awards pursuant to such claims are treated as compensation for Federal tax purposes. Id. In addition, general 409A does not apply to the payment of, or reimbursement for, attorney's fees incurred in connection with such a claim. Id.

The amounts must be paid with respect to an actual bona fide claim for damages under the applicable law. The payment of an amount upon the execution of a waiver does not necessarily indicate that the amounts are paid as a settlement of an actual bona fide claim. Id.

[221] Treas. Reg. § 1.409A-1(b)(10) [pg. 249]. For example, a change to the timing of the payment of a pre-existing amount of deferred compensation as part of such a settlement would be subject to the rules governing accelerated payments and subsequent deferral elections. Id.

[222] If the severance is payable over several years, it would appear that the arrangement could be bifurcated, if so designated, so that payments for the first few months could be paid under the short-term deferral exception, and for remaining payments the six-month delay under § 409A would be satisfied since six months will have elapsed by then.

schedule as defined in Treas. Reg. § 1.409A-3(i)(1) or upon a separation from service as defined in Treas. Reg. § 1.409A-1(h); (iii) changes to time and form of payment may be subject to the restrictions of § 409A; and (iv) the deferral would have to be reported, as discussed below.

G. <u>Immediate Taxation, Additional 20% Tax & Interest; Information Reporting</u>.

Immediate Taxation, 20% Additional Tax, and Interest on Underpayment. Failure to comply with the above § 409A deferred compensation requirements for an employee's taxable year will cause there to be immediate taxation of the total amounts deferred at the end of the taxable year, to the extent not previously included in income, and provided that the amounts are vested.[223] The tax applies to all compensation deferred under the plan (and all aggregated plans of the same type) through the end of the taxable year for the participant(s) with respect to which the failure relates.[224] The tax is increased by an additional tax equal to 20% of the compensation included in income, as well as interest on the underpayments (the income tax and 20% additional tax due on the deferred compensation) at the underpayment rate plus one percent from the time of original deferral or vesting (premium interest).[225]

State Tax. Certain states may also impose taxes on deferred compensation that fails § 409A. See above. For example, California imposes an additional 20% state tax for noncompliant deferrals under the § 409A. However, if the state tax law is silent, and the state is a conforming state it is not entirely clear if the state would tax the hypothetical inclusion in income. It would appear that the state tax should not apply since it is merely a hypothetical inclusion in income for purposes of § 409A. Certainly in a nonconforming state there should be no extra state tax liability for 409A violations since the law of that state does not automatically recognize U.S. inclusions in income.

Medicare Not Applicable to 409A. IRS Q&As provide that: "Section 409A has no effect on FICA (Social Security and Medicare) tax."[226]

Calculation of Amount Includible in Income and Additional 20% Tax; Taxed Only for Years of Failure Assuming Deferral was Vested in that Year. For deferrals that do not comply with § 409A, the IRS has given interim guidance on how to determine the total amount deferred.[227] Proposed

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[223] Code § 409A(a)(1)(A).

[224] Id. Prop. Treas. Reg. § 1.409A-4(a)(1)(i). For example, if a deferred compensation plan covering all executives allowed impermissible distributions for the Section 16 insiders, then only the Section 16 insiders would be subject to the income and penalty tax. Conference Report.

Deferred amounts from prior to 2005 that were properly grandfathered could presumably be disregarded.

[225] Code § 409A(a)(1)(B). This 20% additional tax is not an excise tax but an additional income tax.

The interest is on the underpayments that would have occurred had the deferred compensation been included in income from the date of deferral or vesting, as discussed further below. Code § 409A(a)(1)(B)(ii).

[226] IRS FAQs on website at http://www.irs.gov/retirement/article/0,,id=186222,00.html , 2007 WL 2295798, and FAQs re 409A and Deferred Compensation (August 7, 2007).

[227] Under Notice 2006-100 and Notice 2007-89, if deferrals in 2005, 2006 or 2007 do not comply with § 409A, and they are subject to a substantial risk of forfeiture and have not previously been included in income, the following rules apply: (i) for account balance plans as defined in regulations under Code § 3121(v)(2) (such as a defined contribution SERPs) the amount includible in income is the account balance on December 31 of the applicable year plus the amount paid in that year; (ii) for non-account balance plans (such as defined benefit

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Treas. Reg. § 1.409A-4[228] provides new guidance on the calculation of amounts includible in income and additional taxes under Code § 409A where there is a failure to meet § 409A requirements.[229]

> (i) *Amounts Includible in Income for Year of 409A Failure.* Under the proposed regulations, as stated above, amounts includible in income, in the employee's taxable year due to a failure to meet the requirements of § 409A in that year will be the total amount deferred under the plan for the taxable year that were not previously included in income, as well as amounts paid to the employee in that year.[230] "Total amount deferred for a taxable year" means the present value of the future payments to which the employee has a legally binding right under the plan (and all aggregated plans) as of the last day of the taxable year.[231] Thus, amounts includible in income will be all amounts deferred as of year-end for all years under all aggregated plans, plus distributions made in that year minus unvested amounts.
>
> (ii) *Included in Taxable Year of Failure Based on Amount Deferred and Vested at End of Year.* The tax will only apply to the taxable year of the 409A failure, but will not apply to later taxable years during which the plan complies with § 409A.[232] As stated below, the amount deferred will be the account balance or present value of future payments (depending on the type of plan, as discussed below, and is determined on the last day of the employee's taxable year.[233] To the extent such amount was already properly included in income in a prior year, such amount need not to be included in income in the current year.[234] For example, if a deferred compensation plan has a balance

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SERPs) the amount includible in income is the present value as of December 31, of all future payments to which the employee has a legally binding right; (iii) for stock rights covered by § 409A (such as discounted options) the amount includible in income is the amount the holder would have to include in income if the right was immediately exercisable and exercised on December 31; and (iv) for other deferred amounts (e.g. non-account balance plans that are not reasonably ascertainable) the amount includible in income is to be determined using a reasonable good faith approach of a reasonable good faith method. See also, Prop. Treas. Reg. § 1.409A-4(b)(2), discussed below.

228 73 Fed. Reg. 74380 (Dec. 8, 2008).

229 The regulations will not be effective until after issuance of final regulations (i.e., effective for taxable years beginning on or after the issuance of final regulations according to the Preamble to Final Regulations, 73 Fed. Reg. at 74392, or for taxable years ending on or after publication of the final regulations according to Prop. Treas. Reg. § 1.409A-4(h)). Before such date taxpayers may rely on the proposed regulations only to the extent provided in further guidance. Preamble to Final Regulations, 73 Fed. Reg. at 74392

230 Prop. Treas. Reg. § 1.409A-4(a)(1)(i). Note that under the proposed regulations deferred compensation amounts that are subject to § 409A will not be subject to taxation until they vest.

231 Prop. Treas. Reg. § 1.409A-4(b)(2).

232 Prop. Treas. Reg. § 1.409A-4(a)(1)(ii). The proposed regulations reject the view that a § 409A failure is a continuing failure when it continues to impact amounts deferred under the plan.

233 Prop. Treas. Reg. § 1.409A-4(a)(2). Thus, if the amount vests during the year (not later than December 31), it will be includible in income.

234 Prop. Treas. Reg. § 1.409A-4(a)(3)(i).

of $100,000 at the end of 2011 and a balance of $250,000 at the end of 2012, and in both years it does not meet the § 409A requirements, $100,000 will be included in income in 2011 and $150,000 will be included in income in 2012.[235]

(iii) *Going Back to Prior Years of Failure*. Under the Internal Revenue Code and proposed regulations, for each taxable year in which a 409A failure occurred, 409A taxes would be due for such years.[236] For example, if it is discovered that there was a 409A failure since 2005 (first year 409A effective), and there is no cure procedure, immediate tax and 20% tax and penalty interest under § 409A would be due for the earlier years in which a 409A failure also existed (requiring amending the returns for those prior years), although such tax would reduce the tax due for later taxable years. One would not need to go back and amend the returns for closed years in which the statute of limitations has run.[237] For a documentary error, one could argue that since documentary compliance was not required until 2009, there was no violation for pre-2009 years.

(iv) *Amounts Nonvested for Full Year(s) of Violation Escape Immediate Taxation; Opportunity to Correct Operational and Documentary Failures Prior to Year of Vesting.* The proposed regulations make it clear that there will only be income tax and additional taxes and interest under § 409A in the year of failure assuming the deferred amounts are vested during such year.[238] Thus, as stated in the Preamble to the proposed regulations, if deferred amounts under a plan are unvested, and a deferral election or acceleration that does not comply with § 409A (in form or operation) occurs in such year but the plan complies in form and operation in the year in which the amounts vest, there will be no § 409A tax or penalty.[239] This gives a plan sponsor an opportunity to correct both operational and documentary violations in a year prior to the year of vesting, so that § 409A tax will be avoided entirely. (Note, however, that deferred compensation amounts of the same type, e.g., contributions to all the participants' account balance plans, will be aggregated under Treas. Reg. § 1.409A-1(c)(2) discussed above.[240]) The IRS will, however, under special anti-abuse provisions, disregard the fact that the deferred amounts are not yet vested and will impose tax under § 409A as if vested if the facts and circumstances indicate that the employer has a pattern or practice of permitting changes in time and form of payment in years prior to vesting.[241]

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235 Prop. Treas. Reg. § 1.409A-4(a)(3)(ii).

236 IRC § 409A(a)(1)(1)(A); Prop. Treas. Reg. § 1.409A-4(a)(1)(i).

237 Prop. Treas. Reg. § 1.409A-4(a)(1)(ii) Ex. 2.

238 Prop. Treas. Reg. §§ 1.409A-4(a)(1)(i)(B), -4(a)(1)(ii)(A) & -4(a)(2)(i). See likewise, Preamble to Final Regulations, 73 Fed. Reg. 74380, 74381-2 (Dec. 8, 2008).

239 Preamble to Final Regulations, 73 Fed. Reg. at 74382.

240 Prop. Treas. Reg. § 1.409A-4(f)(2) and Preamble to Final Regulations, 73 Fed. Reg. at 74382 n. 2.

241 Prop. Treas. Reg. § 1.409A-4(a)(1)(ii)(B); Preamble to Final Regulations, 73 Fed. Reg. at 7382. See similar anti-abuse provisions in Prop. Treas. Reg. § 1.409A-4(b)(7).

(v) *General Definition of Total Amount Deferred – Present Value of Future Payments (for Non-Account Balance Plans)*. As stated above, except as otherwise provided, total amount deferred is defined as the present value (as of the last day of the taxable year) of future payments as well as any payments made to the employee during the taxable year.[242] This general rule would be applicable to non-account balance plans. The present value must be determined using reasonable actuarial assumptions.[243] See below for definitions of total amount deferred applicable to other types of plans.

(vi) *Where Amount is Not Knowable at End of Year*. Where the amount payable for purposes of determining the amount deferred is determined by a formula that is not knowable at the end of the taxable year, e.g., deferral of 1% of the employer's net profits for upcoming years, the amount payable is determined based on facts and circumstances as determined in good faith (taking into account contingencies).[244]

(vii) *Alternative Times or Forms of Payment*. Where there are alternative times or form of payment, the alternative with the highest present value will be used for calculation of the amount deferred.[245] For example, if an employee can receive a distribution on the earlier of Jan. 1, 2020 or termination, the amount deferred is based on the present value of the amount that would be payable if he terminated employment at the end of the current taxable year.[246] If eligibility for time and form of payment depends on status of the employee as of a future date, the employee is assumed to continue service until such future date.[247] For example, if an employee is eligible to receive payment at age 62 if still employed on that date, then he or she is deemed to continue to be employed and the deferral amount will be based on the most valuable form of payment.[248]

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242 Prop. Treas. Reg. § 1.409A-4(b)(2)(i). One can discount this amount for possibility of death. Id.

243 Prop. Treas. Reg. § 1.409A-4(b)(2)(ii). If unreasonable actuarial assumptions are used, the IRS will calculate present value using the applicable federal rate under Code § 1274(d) and applicable mortality table under Code § 417(e). Id.

Crediting of earnings and losses under the plan (as of the last day of the year) will be respected only to the extent they reasonably reflect the value of the employee's rights under the plan. Prop. Treas. Reg. § 1.409A-4(b)(2)(iii).

244 Prop. Treas. Reg. § 1.409A-4(b)(2)(iv).

Except as otherwise provided in the proposed regulations, the deferred amount is not discounted for restrictions on distribution or non-substantial risks of forfeiture (e.g., noncompetition). Prop. Treas. Reg. § 1.409A-4(b)(2)(v).

245 Prop. Treas. Reg. § 1.409A-4(b)(2)(vi)(A).

246 Prop. Treas. Reg. § 1.409A-4(b)(2)(ix), Ex. 8.

247 Prop. Treas. Reg. § 1.409A-4(b)(2)(vi)(B).

248 Prop. Treas. Reg. § 1.409A-4(b)(2)(ix), Ex. 1.

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(viii) *Payment Triggers*. If a payment trigger occurs before the end of the taxable year, the deferred amount is treated as payable at the time the payment is scheduled to be made.[249] If the payment trigger has not occurred by the end of the taxable year of the employee, the trigger is treated as occurring on the earliest possible date that it could occur.[250] Payment triggers can be disregarded if the triggers would cause the amount to be subject to a substantial risk of forfeiture or if there is an unforeseen emergency.[251]

(ix) *Amounts That May Qualify as Short-Term Deferrals.* For purposes of calculating the total amount deferred for the taxable year, the right to payment that may, under the arrangements and the facts and circumstances as of the last day of the year, be a short-term deferral, is not included in the total amount deferred.[252]

(x) *Definition of Total Amount Deferred for Account Balance Plans*. For account balance plans, the present value of amounts payable equals the amount credited to the employee's account as of the last day of the taxable year, including principal plus earnings.[253] If the earnings and losses are based on an unreasonably high rate of interest (and is not a predetermined actual investment), the proposed regulations require that the AFR be used.[254]

(xi) *Definition of Total Amount Deferred for Reimbursements and In-Kind Payments*. If amounts deferred are reimbursement arrangements or in-kind benefits that do not meet the 409A exemptions, then the total amount deferred will be based on the maximum amount of expense allowable by the plan at the earliest possible time that it could be incurred and payable.[255]

(xii) *Definition of Total Amount Deferred for Stock Awards*. If a stock right is subject to § 409A, such as a discounted stock option or stock appreciation right, the total amount deferred is the excess of the fair market value over the exercise price on

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In another example, the proposed regulations state that if not married at the current time, deferral amount is valued based on a single annuity and not a joint annuity that may apply if married at a later date. Prop. Treas. Reg. § 1.409A-4(b)(2)(ix), Ex. 2.

249 Prop. Treas. Reg. § 1.409A-4(b)(2)(vii)(A).

250 Id. See also, Prop. Treas. Reg. § 1.409A-4(b)(2)(ix), Ex. 4 that if the employee has the right to accelerate payments, the earliest date he or she can accelerate to is treated as the payment date for deferral of compensation purposes. Prop. Treas. Reg. § 1.409A-4(b)(2)(ix), Ex. 4.

251 Prop. Treas. Reg. § 1.409A-4(b)(2)(vii)(B). See also, Prop. Treas. Reg. § 1.409A-4(b)(2)(ix), Ex. 6.

252 Prop. Treas. Reg. § 1.409A-4(b)(2)(viii).

253 Prop. Treas. Reg. § 1.409A-4(b)(3)(i). One adds to this the amounts paid from such plan during the taxable year. Id.

254 Prop. Treas. Reg. § 1.409A-4(b)(3)(ii).

255 Prop. Treas. Reg. § 1.409A-4(b)(4).

the last day of the taxable year, or if the stock option or SAR is exercised during the taxable year, the total amount deferred will be the excess of fair market value over exercise price on the date of exercise.[256]

(xiii) *Anti-Abuse Provision.* The IRS can disregard the above rules for determining total amount deferred if it determines that the plan provisions have been established to eliminate or minimize the amount deferred.[257]

(xiv) *Additional 20% Income Tax*. With respect to an amount required to be included in income because of a § 409A failure, year, the amount is subject to an additional income tax equal to 20% of the amount required to be included in income under § 409A(a).[258]

(xv) *Premium Interest Tax on Deemed Underpayments*. Amounts required to be included in income for each taxable year are subject to an additional income tax equal to the interest at the underpayment rate under Code § 6621 - plus 1% - on of the underpayments that would have occurred had the deferred compensation been includible in income for the taxable year first deferred and vested.[259] Presumably, the interest covers the 20% additional tax as well because it is also an amount required to be included in income. Presumably, there would not be both a regular interest on underpayment and premium interest on underpayment, because the premium interest is applied from the hypothetical year when amounts would have been included in income,

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[256] Prop. Treas. Reg. § 1.409A-4(b)(6). The Preamble to Final Regulations, 73 Fed. Reg. at 74399, states that the spread can be used rather than a more sophisticated measure (such as Black-Scholes), because it will balance out over the period of the deferral.

[257] Prop. Treas. Reg. § 1.409A-4(b)(7). For example, if the plan provides that the deferred amount is payable on separation from service but also provides that the amount will be forfeited on a separation from service occurring on the last day of the taxable year, this provision would be disregarded. Id.

[258] Code § 409(a)(1)(B)(i)(II); Prop. Treas. Reg. § 1.409A-4(c).

[259] Code § 409(a)(1)(B)(ii); Prop. Treas. Reg. § 1.409A-4(d)(1).

Prop. Treas. Reg. § 1.409A-4(d)(2) provides rules for identifying the taxable year in which amount was first deferred and vested, for purposes of the interest tax. See example at Prop. Treas. Reg. § 1.409A-4(d)(2)(ii), Ex. 1 (where the total amounts deferred at the end of years one, two, three and four of $110,000, $275,000, $495,000 and $770,000 respectively, and the 409A violation only occurs in year four, only the $770,000 is includible in income in year 4, but to calculate the premium interest tax must be allocated based on the years in which the first deferral amount occurred (provided it is also vested), which would be $110,000 in year one, $165,000 in year two, $220,000 in year three and appropriate interest from each prospective year).

The underpayment rate for a quarter under § 6621(a)(2) is the federal short-term rate plus 3 percentage points and already has built in daily compounding of interest. This amount is determined annually (presumably an average of the interest rates on the four quarters).

See also, Prop. Treas. Reg. § 1.409A-4(d)(3) for calculation of hypothetical underpayment for the taxable year during which the first deferral took place (assuming it was vested), and see, Prop. Treas. Reg. § 1.409A-4(d)(4) for calculation of hypothetical premium underpayment interest.

while the regular interest on underpayments only applies to actual underpayments, not hypothetical underpayments.[260]

As stated above, § 409A amounts are not subject to FICA. It is unclear whether states (e.g., conforming states) would impose state tax on tax the hypothetical underpayment subject to the premium interest tax. This is discussed further above.

(xvi) *Payments of Deferred Compensation in Years after Year Included in Income under § 409A*. Under Code § 409A(c) any amount already included in gross income under § 409A need not be included in gross income (under any provision of the Code) in a later taxable year. As provided in the proposed regulations, the amount included in income under § 409A serves as the tax basis that is used to minimize the tax liability at the time of distribution.[261]

(xvii)*Permanent Forfeiture of Deferred Amount Previously included in Income*. If deferred compensation amounts includible in income under § 409A are ultimately forfeited (e.g., because the company is in default, or a noncompete was violated or due to investment losses), the employee is entitled to a deduction at the time of such forfeiture.[262]

Information Reporting and Withholding for Deferred Compensation Plans Under § 409A. Deferrals under a nonqualified deferred compensation plan must be reported on a Form 1099 or W-2, regardless of whether they are includible in gross income.[263] For deferrals that do not comply with § 409A, IRS notices provide that beginning in 2005 the employer or payer must report such noncompliant deferrals as wages in box 1 of Form W-2 or as compensation in box 7 of Form 1099-MISC, and must also include them as Code Z in box 12 of Form W-2 or in box 15b of Form 1099-MISC.[264]

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[260] For example, if amounts are deferred in 2010 and there is a violation under that plan in 2013, there would be premium interest from 2010 to 2013. If the individual does not pay the taxes until 2015, there would be ordinary underpayment interest and penalties from 2013 when the tax was due until you paid them in 2015.

[261] Prop. Treas. Reg. § 1.409A-4(f)(1). Plan aggregation rules under § 1.409A-1(c)(2) apply. Prop. Treas. Reg. § 1.409A-4(f)(2).

For example, if $10,000 deferred in year one is taxed under § 409A, and there is a distribution of $5,000 in year three the entire amount would be excluded from income at that time. Preamble to Final Regulations, 73 Fed. Reg. at 74390. See more examples at Prop. Treas. Reg. § 1.409A-4(f)(3).

[262] Prop. Treas. Reg. § 1.409A-4(g).

[263] Code §§ 6041 (g)(1) & 6051(a)(13). For a nonaccount balance plan the amounts must also be reported once they become reasonably ascertainable. Notice 2005-1, Q&A 26. See also, Notice 2008-115. If the amount of deferrals for a year does not exceed $500, reporting is not required. Q&A 27. The reporting requirements are effective for amounts deferred after 2004. Notice 2005-1, Q&A 28.

[264] Notice 2005-1, Notice 2006-100 and Notice 2008-115.

Notice 2008-115 provides interim guidance on the inclusion of amounts taxable under § 409A into income, and on withholding of such amounts, and determining amounts includible in income under § 409A. It further provides that an employee who complies with rules of the notice will not be liable for additional tax as a result

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If, however, the deferrals are not includible in income (i.e., they are 409A compliant), the employer or payer must report the total amount of deferrals for the year that comply with § 409A as Code Y in box 12 of Form W-2 or in box 15a of Form 1099-MISC.[265] However, the IRS has waived the reporting the 409A compliant amounts deferred until the IRS issues further guidance.[266]

There is no withholding obligation on the 20% additional tax.[267]

No Ruling Position. The IRS will not rule on income tax consequences of establishing, operating, or participating in a nonqualified deferred compensation plan under § 409A, but the IRS generally will rule on the application of certain other tax law provisions (such as FICA and estate and gift taxes) to taxpayers who participate in those plans.[268]

Indemnification for 409A Violations. Companies may wish to consider whether to indemnify affected employees for inadvertent violations. [269]

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of future IRS guidance. The notice also provides that taxpayers may rely on the proposed regulations for calculation of taxes even to the extent contrary to Notice 2008-115.

Failure to include information required on Form W-2 can subject the employer to penalties under Code §§ 6721 & 6722 (absent reasonable cause under § 6724).

[265] Notice 2005-1 Q&As 29, 30, 33 & 35, Notice 2006-100 and Notice 2008-115.

[266] Notice 2008-115, § III.A exempts taxpayers from reporting the amounts deferred that comply with § 409A until the IRS issue further guidance. (Similarly Notice 2006-100 and Notice 2007-89 provided that for 2005 – 2007 the employer and payers are exempt from reporting the deferrals that comply with § 409A. See also Notice 2005-94.

[267] Notice 2008-115 § III.B.

[268] Rev. Proc. 2008-61, modifying and amplifying Rev. Proc. 2008-3.

[269] Some senior executives ask for gross-ups in their employment agreements for § 409A taxes for severance, although management will generally reject such a request, because the six-month delay can often solve the § 409A issues.

Bringing a lawsuit against the employer (or other party) for 409A violation would have certain obstacles. If it involves an ERISA plan (like a deferred compensation plan) the claims would likely be limited to fiduciary breaches. If it did not involve an ERISA plan (e.g., an employment contract) the claim would likely be based on breach of contract.

H. Correction For 409A Operational and Documentary Failures.

IRS Audits. The IRS has begun to audit companies for compliance with § 409A.[270]

Notice 2008-113 - Operational Failure Corrections. Notice 2008-113 provides relief from Code § 409A operational failures by providing certain methods for correcting such failures, provided the corrections are made in the year of failure or in certain cases in the first or second year following the year of failure.[271] These are self-correction methods and do not require individual IRS approval. The notice also provides transitional relief for certain operational failures occurring before 2008. The relief under Notice 2008-113 does not cover documentary errors.

Eligibility for Operational Correction Program. To be eligible for the correction program, (i) the employer must take reasonable steps to avoid recurrence of the error, (ii) the operational failure must be unintentional, and (iii) the employee may not be under audit (except for corrections in the same year).[272] The employee must repay to the employer the amount erroneously paid (plus interest if applicable), or this amount can be offset against new compensation.[273] The relief in the notice is not available for a taxable year in which the employer experiences a financial downturn where it may not be able to pay the amount deferred when due.[274] Where relief involves the employee repaying the employer, this refers to gross amount paid before application of any withholding tax, except that if the employer has already made a tax correction the employee will only have to repay the net amount after withholding.[275]

Corrections for Operational Failures in the Same Taxable Year or for Non-Section 16 Insiders in Year Following the Year of Failure.

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270 IRS Information Document Requests (IDRs) to companies being audited have recently included a number of questions relating to 409A compliance, including, e.g., list for all plans providing for a legally binding right in one year and payment in a subsequent year, basis for position that arrangements are not subject to § 409A, arrangements that comply with § 409A, amounts paid under deferred compensation arrangements, payments that are delayed or accelerated, terms of the nonqualified deferred compensation plan's deferral and subsequent deferral elections, violations of § 409A and how they were reported (on W-2 or 1099), identify all "specified employees" and any payments of nonqualified deferred compensation made to specified employees within six months after separation from service, participation in correction programs, information on stock options and SARs that may be subject to § 409A, description of any nonqualified deferred compensation funding resulting from a decline in the company's financial condition. See Melbinger Executive Compensation Blog (10/13/09) http://www.winston.com/index.cfm?contentID=19&itemID=159&itemType=25&postid=247

271 Notice 2008-113, 2008-51 I.R.B. 1305. Note that Notice 2008-113 supersedes Notice 2007-100 (which outlined potential correction program).

272 Notice 2008–113, § III.A-D.

273 Notice 2008–113, § III.E.

274 Notice 2008–113, § III.F.

275 Notice 2010-6 § XIII.A. adding new § III.K to Notice 2008-113. See also Notice 2010-6 § XIII.B. adding new § III.L to Notice 2008-113, regarding determining amount that has been erroneously paid to the employee if such payment was in the form of property, such as stock.

(i) Failure to Defer Amount to a Subsequent Year Corrected in the Taxable Year Paid or for Non-Section 16 Insiders in the Next Taxable Year. If there was a failure of the employer to defer an amount to a later taxable year as required by the plan, by an election form or by § 409A (but not a failure to delay 6 months for specified employees), the employee may, in order to comply with this notice, return the amounts until the end of the employee's taxable year in which the error occurred. If the employee is not a § 16 insider (officer, director or 10% beneficial owner), the amounts may also be returned to the employer in the taxable year immediately following the year of error.[276]

For corrections made in the same taxable year of error, if the total amount of erroneous payments exceeds the Code § 402(g) deferral limit ($16,500 in 2010) and the employee is a § 16 insider, interest on the erroneous amount returned is charged at the short-term applicable federal rate times the ratio of the days not repaid in the year of error to 365 days.[277] If a correction is made in the year following the year of error, interest at the short-term AFR must be paid.[278]

No income tax withholding is required on the return of erroneous payments in the year of error, but an adjustment to FICA tax withholding may be required. However, for corrections for non-section 16 insiders made in the year following the year of payment, the amount incorrectly paid in the first year must be reported on Form W-2 for the year of payment and the employee will receive a deduction in the subsequent year when the amount is repaid.[279] The employee must include interest at the short-term AFR rate. The correction avoids the 20% additional tax and premium interest tax.

(ii) Failure to Defer Amount to a Time that is in the Same Taxable Year Corrected in Taxable Year of Failure or for Non-Section 16 Insiders in the Next Year. If there is a failure to defer an amount payable in the same taxable year, the amount may be repaid in the same taxable year, or for those who are non-section 16 insiders (at any time during taxable year of failure and next taxable year) in the next taxable year.[280] If the amount is returned in the next taxable year, the original payment is subject to withholding and there is a deduction in the year of return.[281] The employee pays interest at the short-term AFR rate.[282] The correction avoids the 20% additional tax and the premium interest tax.

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[276] Notice 2008-113, §§ IV.A & V.B.

If repayment would create a hardship, an employee (other than a § 16 insider) may repay the amounts over two years from the income tax filing due date for the year of payment with interest. Id.

[277] Notice 2008-113, § IV.A.

[278] Notice 2008-113, § V.B.

[279] Notice 2008-113, §§ IV.A & V.B.

[280] Notice 2008-113, §§ IV.B. & V.C.

[281] Id.

[282] Notice 2008-113, § IV.C.

(iii) Excess Deferred Amount Corrected in the Same Taxable Year or for Non-Section 16 Insiders in the Next Taxable Year. Where an amount that should not have been deferred to a later year is erroneously deferred and credited to the employee's account, such amount may be corrected by paying it to the employee by the end of the employee's taxable year in which the excess deferral was made, or for non-section 16 insiders (at any time during taxable year of failure and next taxable year), in the taxable year following the year of error.[283] The employer is not required to pay interest. The employee is taxed in the year of cure. The correction avoids the 20% additional tax and the premium interest tax.

(iv) Correction of Discounted Exercise Price for Options or SARs. Where stock options or SARs are erroneously granted at below fair market value on the date of grant, thereby negating the § 409A exclusion for options and SARs, the exercise price may be reset to fair market value on date of grant, provided such correction is made within the taxable year of grant or in the case of a non-section 16 insider, in the taxable year following the year of grant.[284] The correction avoids the 20% additional tax and the premium interest tax.

Limited Relief from Premium Interest Tax for Operational Corrections in Second Year after Error. If the above errors for failure to defer or for excess deferrals are not corrected until the second taxable year after the year of the error, and the amount involved does not exceed the Code § 402(g) limit ($16,500 in 2010), there will be no premium interest tax under Code § 409A(a)(i)(B)(i)(I) although there will be the 20% additional tax under § 409A(a)(1)(B)(i)(II). Where it involves a § 16 insider the amount must be paid back with interest at the short-term AFR.[285] There is also more broad relief from the premium interest tax but not the 20% additional tax for non-section 16 insiders even where the § 402(g) limit is exceeded, but it requires that after repayment the deferral is extended so that the right will be to receive the amount in the same number of days after repayment as the number of days early that the payment was originally made.[286] In the case of failure to defer, the correction of returning the money will not result in a credit of income tax since under § 409A the violation results in taxing the amount from when it was to be deferred.[287]

Limited Transitional Relief for Pre-2008 Operational Failures. There is limited transitional relief for employees who were not section 16 insiders in the year of failure, that where the

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[283] Notice 2008-113, §§ IV.C & V.D.

Notice 2010-6 § XIII.B adds to Notice 2008-113 § V.D that this excess deferral correction also applies to a failure where under the terms of a plan and an applicable deferral election an amount that should have been paid under the plan is not paid to the employee during the taxable year in which falls the payment date, and the failure to make such payment results in an operational failure under § 409A(a).

With respect to non-insiders, the employer may (but is not required to) pay reasonable interest to the employee to reflect the time value of money with respect to the late payment. Notice 2008-113, § IV.C(2). However, with respect to Section 16 insiders, the remaining account balance is adjusted for earnings retroactive to the date the excess amount was incorrectly credited to the employee's account or otherwise incorrectly treated as deferred under the plan. Notice 2008-113, § IV.C(3).

[284] Notice 2008-113, §§ IV.D & V.E.

[285] Notice 2008-113, §§ VI. B & C.

[286] Notice 2008-113, §§ VII.B & C.

[287] Notice 2008-113, § VII.B.3.

operational failure occurs on or prior to December 31, 2007 a correction made during 2009 will be treated as made during the year following the year of failure (as if made in 2008).[288]

Information and Reporting Requirements for Operational Corrections. Notice 2008-113 provides information and reporting requirements by the employee and employer to make the operational corrections. For example, with respect to same year corrections, Notice 2008-113 provides that the employer must attach to its federal income tax return for its taxable year in which the failure occurred a statement entitled "Section 409A Relief under Section IV of Notice 2008-113" with specific information about the correction, and the employer must provide to each affected employee a similar statement by the W-2 due date.[289] Notice 2010-80 amends this provision so that notice to the employee is not required for corrections in the same year of payment.[290]

Correcting Documentary Errors Prior to Year of Vesting. The above correction program does not apply to documentary errors. However, as provided in Proposed Treasury Reg. § 1.409A-4(a), discussed above, if a deferred compensation arrangement does not meet the requirements of § 409A prior to the year of vesting, it can be corrected prior to such year - both with respect to operational defects and form (documentary) defects - without incurring tax or penalties, as long as there is no abusive use of changes in time and form of payment in years prior to vesting.

Notice 2010-6 - Voluntary Corrections for 409A Documentary Failures. IRS Notice 2010-6, 2010-3 I.R.B. 275 (January 5, 2010), allows taxpayers to voluntarily correct many documentary failures under Internal Revenue Code § 409A. Taxpayers may rely on Notice 2010-6 for taxable years beginning in 2009.[291] Correction for documentary failures generally requires the following: (i) The same correction must be made by the employer for substantially similar failures for all its deferred compensation arrangements.[292] (ii) The employer and employee may not be under audit with respect to nonqualified deferred compensation.[293] (iii) The failures are not intentional and are not listed transactions.[294] (iv) For many of the correction methods below, income tax and additional 20% tax - but not premium interest - must be paid for a portion of the amount deferred if a violation would have occurred within one year.[295] (v) Linked plans and stock rights plans are not eligible for documentary correction (except as provided in the next paragraph).[296] (vi) Plan aggregation rules of the 409A regulations do not apply to documentary errors, (Treas. Reg. §1.409A-1(c)(3)) and therefore a failure with

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288 Notice 2008-113 § VIII. (For employees who were not insiders in the year of failure (e.g., in 2007) but were insiders in the year of correction (2009), the first sentence of § VIII implies that relief would be available, even though under § V the person may not be a section 16 insider in the year following the year of failure.)

289 Notice 2008-113 § IX.

290 Notice 2010-80 § III.H amending Notice 2008-113 § IX.

291 Notice 2010-6 § XIV.

292 Notice 2010-6 § III.B.

293 Notice 2010-6 § III.C.

294 Notice 2010-6 § III.D.

295 Notice 2010-6 § III.E.

296 Notice 2010-6 § III.G.

regard to one plan will not cause the other plans to be subject to 409A tax.[297] Also, short-term deferral errors are not correctable under Notice 2010-6.

Certain Linked Plans and Stock Rights are Included in Documentary Corrections. Notice 2010-80 amends Notice 2010-6 to provide that the documentary corrections can be utilized: (i) by linked plans (nonqualified plans linked with qualified plans) with document failures if the linkage does not affect the time and form of payment of amounts under the plans; and (ii) by stock rights (stock options and stock appreciation rights) that were intended at the time of grant (or upon a modification pursuant to applicable transition relief) to be subject to and compliant with § 409A but that have a plan document failure.[298]

Ambiguous Documentary Plan Terms that Provide for a Payment "As Soon as Practicable." The notice provides that a plan that allows payments on distribution events "as soon as reasonably practicable" does not fail to meet the requirements for designated distribution events as long as the employer does not have a pattern or practice of making late payments that do not qualify under the timeliness exception of the regulations.[299]

Permissible Payment Events with Ambiguous Documentary Definitions such as "Termination of Employment" or "Acquisition." A plan that designates a payment event but does not define the payment event or has an ambiguous definition of the payment event will still be compliant, as long as: (i) the provision could reasonably be interpreted to be compliant with § 409A, (ii) the employer does not have a pattern or practice of applying an interpretation that does not satisfy § 409A and (iii) the provision is not interpreted by a court in a way that violates § 409A.[300] For example, "termination of employment" as a payment event can be interpreted to mean only events that are a separation from service under § 409A, and not events that do not constitute a separation from service under 409A, as long as there is no pattern of applying a non-409A definition. Similarly, the term "acquisition" can be interpreted to be a change in control as defined in § 409A.[301] Likewise, the term "acquisition" is valid if

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297 Notice 2010-6 § III.J.

298 Notice 2010-80, 2010-51 I.R.B. __, § III.A.

299 Notice 2010-6 § IV.A. If payment is inadvertently made after the fifteenth day of the third month after the year of the event, but there is no pattern of making late payments, there will be only an operational failure, which may qualify for operational correction under Notice 2008-113. Notice 2010-6 §§ IV.A. and IV.C Ex. 1.

The notice does not require a plan that has the "as soon as practicable" after a payment event to add a provision to correct itself.

The "as soon as practicable" language should also suffice for a short-term deferral payable as soon as practicable without stating the 2-1/2 month period, and for expense reimbursements payable as soon as practicable without stating that it must be paid by the end of the next taxable year. These provisions, however, do not appear to be subject to the written plan requirements of Treas. Reg. § 1.409A-1(c)(3), and therefore the ambiguity of the provisions should not matter as long as in operation the requirements are met.

300 Notice 2010-6 § IV.B.1 & first sentence of § IV.B.2.

301 Notice 2010-6 § IV.B. See also, § IV.C Ex. 2 and 3.

intended to be change in control as defined by Treas. Reg. § 1.409A-3(a)(5). Id. No plan amendment is required in the above cases to comply with § 409A.[302]

Documentary Correction of Impermissible Definitions of Payment Events

(i) Impermissible Definition of Separation From Service. If a plan allows distribution on an event involving a change in the relationship between the employee and the employer relating to: (i) the level of services provided by the employee (such as a change from full-time to part-time status), (ii) a change in the capacity in which the employee provides services (such as change from employee to independent contractor) or (iii) a change in the recipient of the services provided by the employee (such as change from one subsidiary to another subsidiary), but which is not separation from service under Treas. Reg. § 1.409A-3(a)(1), the plan can be corrected before an event occurs that would meet the plan definition but not the regulatory definition of separation from service. The correction requires an amendment of the plan to provide payment on separation from service only if it meets the requirement of Treas. Reg. § 1.409A-3(a), provided the amendment does not expand or narrow a payment event except as needed to satisfy the regulatory definition of separation from service. If within one year after the correction, an event occurs that would have been a separation from service under the plan's old definition but would not be a separation under the regulatory definition, the employee must include 50% of the amount deferred in income for purposes of income tax and 20% additional tax on the amount included in income (but not premium interest, as stated above).[303]

(ii) Impermissible Definition of a Change in Control Event. If a plan provides for payment on a sale or change in effective control that would not satisfy the change in control definition of Treas. Reg. § 1.409A-3(a)(5), then as in the case above the plan may be corrected before an event occurs that meets the old plan definition but not the regulatory definition, provided the amendment does not expand to payment event.[304] If within one year after correction a transfer occurs that is a change of control event under the old plan definition but not the regulatory definition, the employee must include 25% of the amount deferred in income for purposes of income tax together with the 20% additional tax.[305]

(iii) Impermissible Definition of Disability. If a payment event relating to incapacity would be a disability payment event under the plan but not under Treas. Reg. § 1.409A-3(a)(2),

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[302] If the plan contains a provision requiring that the terms be interpreted to comply with § 409A, the ambiguous provision will be treated as not ambiguous and will satisfy § 409A even without the above provision. § IV.B.1.

If an amount is paid (or not paid) in a manner that is not compliant with § 409A, that payment (or failure to make payment) may be treated as an operational failure eligible for relief under Notice 2008-113 despite the interpretation of the written plan provision in a manner that does not comply with § 409A, provided that the plan is amended to fix such interpretation before the end of the employee's taxable year during which the operational failure is corrected. § IV.B.2. The above amendment may be made by (i) adding language so that terms of plan be interpreted as necessary to comply with § 409A, or (ii) setting forth explicit definitions of the terms of the plan that comply with § 409A, provided that the amendment may not expand the definition to include a new payment event or to take away a payment event (other than the required change). Id.

[303] Notice 2010-6 § V.A.

[304] Notice 2010-6 § IV.B.

[305] Id.

the plan may be corrected by conforming to the regulatory definition prior to the occurrence of a payment event that would meet the old plan definition but not the regulatory definition.[306]

Correcting Impermissible Payment Periods (Including by Release) Following a Permissible Payment Event

(i) Payment Periods of Longer than 90 Days Following a Permissible Payment Event. Where payment may be made later than 90 days (and earlier than 366 days) after the payment event (see Treas. Reg. § 1.409A-3(b)), the plan may be corrected by removing or shortening the period after the payment event in which the amount can be paid to 90 days or less as well as by eliminating any ability of the employee to designate the taxable year in which paid.[307] This amendment must be made before such a payment event occurs or within 90 days thereafter. If payment the permissible event under the pre-corrected plan but not under 409A occurs, 50% of the amount deferred is included in income under § 409A as well as the 20% additional tax.[308]

(ii) Payment Periods Following a Permissible Payment Event Dependent on the Employee Executing a Release or Other Employment-Related Actions. If a plan provides for payment on a permissible event but conditions the payment on employment-related action of the employee such as executing a release, non-solicitation agreement or non-compete agreement, correction can be made before the permissible payment event occurs by removing the ability of the employee to delay or accelerate the timing of the payment as a result of his or her actions, and fixing the payment date at 60 or 90 days after the payment event (or the last day of a designated period if such designated period were provided in the plan).[309]

As stated above, Notice 2010-80 gives a correction under which plan document will be amended to provide that where payment of severance will be set as not longer than 60 or 90 days following the termination (the permissible payment event), provided that if such 60 or 90 day period begins in the employee's first taxable year and extends into the employee's second taxable year, the payment must be made in the second taxable year (or alternatively the payment can be set for the last day of the period as per the 2010-6 method).[310]

(iii) Transition Relief for Severance With Release Through Dec. 31, 2012. Notice 2010-80 modifies Notice 2010-6 by providing additional transition relief through December 31, 2012 for plans that contain failures involving payments dependent upon the employee executing a release (and the plan is eligible for correction by December 31, 2010), provided that any payments made after March 31, 2011 that could be paid during a period that begins in one taxable year and ends in the subsequent taxable year are made during the subsequent taxable year and provided further that to the

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306 Notice 2010-6 § V.C.

307 Notice 2010-6 § VI.A.

308 Id.

309 Notice 2010-6 § VI.B. As discussed above, when payment of severance is conditioned on the employee's signing a release of claims, and the employee can sign the release at any time, this could cause the severance arrangement to fail to be a short-term deferral or not have a fixed payment date. This can be corrected in the methods described in the paragraph above and the following paragraph.

310 Notice 2010-80 § III.B modifying § VI.B.2 of Notice 2010-6. See Notice 2010-80 § III.D with new additional examples.

extent any amounts remain deferred under the plan, the plan is amended to be compliant by no later than December 31, 2012.[311]

Documentary Correction of Certain Impermissible Payment Events and Payment Schedules

(i) Plans with Permissible and Impermissible Payment Events. If a plan provides for both permissible and impermissible payment events, but does not have employer or employee discretion to pay amounts on different payment events, the plan may be corrected to remove the impermissible payment event(s) before the date a separation from service occurs that could result in impermissible multiple forms of payment for the employee.[312]

(ii) Plans with Only Impermissible Payment Events. If a plan provides only impermissible payment events under § 409A, the plan can be corrected before any impermissible payment event occurs by removing the impermissible payment events and replacing them with a provision for payment on the later of separation from service or the sixth anniversary of the date of correction.[313]

(iii) Correcting Impermissible Toggles. Where there are multiple forms of payment for a single permissible payment event ("toggles"), correction can be made before the payment event. This generally means amending the plan, eliminating all the forms of payment except for the form with the latest final payment date.[314]

(iv) Impermissible Discretion Relating to Payment Schedule Following Permissible Payment Event (Including Subsequent Deferrals). If the plan allows discretion by the employer or employee to change the time or form of payment following a permissible payment event, which is not allowed under Treas. Reg. § 1.409A-2(b) & -3(j), the following will apply. If the plan has a default time and form of payment if no discretion is exercised, and discretion has not been exercised or discretion exercised is revoked more than one year before the payment event occurs then there is no § 409A violation. If however, discretion has been exercised and has not been revoked (or has not been revoked more than a year prior to payment event), then to be eligible to correct, all similar provisions if

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311 Notice 2010-80 § III.C adding § VI.B.3 to Notice 2010-6.

312 Notice 2010-6 § VII.A.

If a permissible payment event has already been elected by or become applicable to the employee, the plan could be corrected to immediately remove impermissible payment events before any occur. If a payment of an impermissible event under the pre-corrected plan occurs within one year after the correction, 50% of the amount deferred must be included in income under § 409A for income tax as well as the additional 20% tax. Id.

313 Notice 2010-6 § VII.B.

Affected employees for whom a pre-correction impermissible payment event occurs within one year of correction must include 50% of the amount deferred in income under § 409A for income tax and 20% additional tax. Id.

314 In the case of separate forms for voluntary or involuntary separation from service, the forms relating to voluntary separation from service should be removed, leaving just a single form relating to involuntary separation from service. § VII.C. If a payment relating to an optional form (toggle) that existed pre-correction occurs, 50% of the amount deferred will be subject to income tax and 20% additional tax. Id.

all the employer's similar plans have discretion removed.[315] In either case the plan must be immediately amended to remove discretion.[316]

(v) Impermissible Employer Discretion to Accelerate Payment Event. If a plan gives the employer discretion to accelerate payment even prior to payment event (which is not allowed under Treas. Reg. § 1.409A-3(j)), the plan must be corrected to remove employer discretion before the date that the service recipient exercises its discretion to accelerate payment and such a change is irrevocable, or if earlier, before the date of payment has been made pursuant to exercise of discretion.[317]

(vi) Impermissible Reimbursement or In-Kind Benefits. Where reimbursement or in kind benefits do not satisfy Treas. Reg. § 1.409A-3(i)(1)(iv), the plan can be corrected before occurrence of any event that would result in the employee becoming eligible to receive the reimbursement or in-kind benefits, and the plan should be amended immediately to provide for reimbursement or in-kind benefits in a way that complies with the 409A regulations.[318]

Correcting Documentary Failure to Include Six-Month Delay. A nonqualified deferred compensation plan of a public company that fails to include a six-month delay for specified employees may be corrected before an event that would trigger the six-month delay occurs, by amending the plan to include the six-month delay and by further providing that the termination payment may be paid to specified employees no earlier than 18 months following correction or, if later, 6 months after the payment event occurs.[319]

Documentary Correction of Impermissible Initial Deferral Elections. With respect to a provision allowing an initial election to defer compensation that does not comply with Treas. Reg. § 1.409A-2(a) (e.g., the requirement that initial elections as time and form of payment be made prior to the taxable year in which the services are performed), but has not yet been applied with respect to the employee, the initial deferral is treated as applied on the date of the applicable deadline. Correction to

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315 Notice 2010-6 § VII.D.

316 If the plan does not have a default time and form of payment, the plan will need to be corrected to remove any employer or employee discretion as to form of payment, and the amendment must choose the time and form of payment with the latest final payment date. Id.

In both cases, if the payment event occurs within one year after the correction, 50% of the amount deferred is subject to income and 20% additional tax. Id.

317 Notice 2010-6 § VII.E.

318 Notice 2010-6 § VII.F

If the event that would have been made in violation of the regulation occurs within one year following correction, the employee must include 50% of the deferred amount in income, as well as the 20% additional tax. Id.

319 Notice 2010-6 § VIII.

If there occurs within the first year after correction a termination payment that would without the correction violate § 409A due to lack of six-month delay, 50% of such amount will be subject to income tax as well as 20% additional tax. Id.

remove the ability to make the impermissible initial deferral election may be made no later than the end of the employee's second taxable year after the year in which the payment event occurs.[320]

Information and Reporting Requirements for Documentary Corrections. An employer with respect to any of the corrections in the notice must attach to its corporate tax returns and to the W-2's and 1099's for the year of failure an exhibit entitled "409A Document Correction Under § ___ of Notice 2010-6," which must include certain information about the correction.[321] The affected employees must also be provided with a statement that the employee is entitled to the relief provided in the applicable provision in Notice 2010-6 with respect to a failure to comply with § 409A, and containing the above information about the correction, and that the employee must attach a copy of the statement to his or her income tax return for the taxable year in which the failure was corrected.[322] Notice 2010-80 modifies Notice 2010-6 to provide that this statement is not required to be furnished by the employer to the employees and is not required to be attached by the employees to their tax returns with respect to transition relief corrections that may be made prior to Dec. 31, 2010, 2011 or 2012, as applicable,[323] although the employer is still required to attach the statement to its return.[324]

Transition Relief for Documentary Errors and Other Provisions of Notice 2010-6

(i) Amendment Period Following Employer's Initial Adoption of a Plan - If a plan provision is eligible for correction under this notice and the document failure is corrected by the end of the calendar year in which the legally binding right occurs or, if later within 2-1/2 months after the legally binding right arises, and all similar provisions of the employer are corrected in the same time period, any amounts paid that would not have been paid if the correction was not made may be treated as operational failures correctable under Notice 2008-113, and there will not be any 409A income tax or 20% additional tax on events occurring within the first year of correction. Notice 2010-6 § X.

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[320] Notice 2010-6 § IX.

[321] Notice 2010-6 § XII.A.

The attachment describing the documentary correction should set forth the name and tax identification number for each service provider affected by the failure, identification of the plan with the failure, a statement that the document failure is eligible for correction (and identifying the specific section of the notice) and stating the amount involved in the documentary error. Notice 2010-6 § XII.B.

[322] Notice 2010-6 § XII.C. The employee must attach to his or her tax return a copy of the above statement regarding the failure. § XIII.D.

[323] The transition relief corrections are in Notice 2010-6 § XI and in Notice 2010-6 § VI.B.3 (as added by Notice 2010-80).

[324] Sections III.E, F & G of Notice 2010-80 amending § XII of Notice 2010-6.

(ii) Transition Relief - Correction of Document Failure Described in the Notice. If a documentary error is eligible for correction under Notice 2010-6 and is corrected by December 31, 2010, the plan may be treated as corrected by January 1, 2009, and thus the income inclusion for the event occurring within one year of correction will not apply, although the failure will be treated as an operational failure under Notice 2008-113.[325]

(iii) Transition Relief - Correction of Impermissible Provisions Linking Nonqualified Deferred Compensation Plans by 12/31/11. If an amount deferred or paid under a nonqualified deferred compensation plan is determined by the amount deferred or paid under another nonqualified deferred compensation plan such that the one or both plans fail to satisfy § 409A, the linkage will be disregarded if the plans are corrected by December 31, 2011. The correction requires that the time and form of payment under the two plans are made identical. If any amounts have been paid in a manner that is not consistent with the amended payment provisions, the payments must be treated as operational failures correctable under Notice 2008-113.[326]

(iii) Transition Relief - Correction by 12/31/11 of Payment Schedules Determined by Timing of Payments Received by Employer. If a nonqualified deferred compensation plan contains a payment provision tied to payments received by the employer that meets the requirements of Treas. Reg. § 1.409A-3(i)(1)(iii) except that it fails to meet paragraphs (C) of (D) (objective method of identifying the payments to the employer and objective schedule under which the payments will be made to the employee) , the payment provision will retain its status as a fixed schedule of payments if the plan is amended by 12/31/2011.[327]

I. Effective Date and Material Modifications.

General Grandfather Rule - Earned and Vested by 12/31/04. The § 409A deferred compensation rules apply to amounts deferred in taxable years after December 31, 2004, but amounts deferred prior to 2005 are grandfathered.[328] An amount is considered deferred before January 1, 2005, if (i) the employee had a legally binding right to be paid the amount and (ii) the right to the amount was earned and vested as of December 31, 2004.[329] A legally binding right would not exist if, e.g., the

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[325] Notice 2010-6 § XI.A.

It is evident from Example 1 in § XI that this transition rule will even help if amended in 2010 but with the impermissible event already occurring prior to the amendment, because the plan is treated as corrected effective 1/1/09 and any requirement of income inclusion as a condition of relief (i.e., that an event occurring within one year that would have impermissibly allowed distribution under the old document, and that the correction occurs before there was any impermissible payment event) will not apply.

[326] Notice 2010-6 § XI.B.

[327] Notice 2010-6 § XI.C.

[328] AJCA § 885(d); Treas. Reg. § 1.409A-6(a)(1) [pg. 385].

Note that, as discussed below, if the plan under which a deferral is made is materially modified after October 3, 2004, it is subject to § 409A and loses its grandfather status even though deferred prior to 2005.

[329] Treas. Reg. § 1.409A-6(a)(1) & (2) [pg. 385 & 386]. See also Notice 2005-1, Q&A 16.

employer has discretion to reduce the amount. A right to an amount would not be earned and vested if the amount is subject to a substantial risk of forfeiture or there is a requirement to perform further services.[330]

If amounts deferred are grandfathered (with a legally binding vested right by December 31, 2004), earnings on the deferred amounts will remain exempt from § 409A even though earned after 2004.[331]

If amounts are deferred pursuant to a collective bargaining agreement in effect on October 3, 2004, these amounts enjoy grandfathering until the end of the term of the collective bargaining agreement, or until December 31, 2009 if earlier.[332]

For account balance plans (a nonqualified deferred compensation plan under which a principal amount is credited to an individual account for the employee) the grandfathered amount is the vested account balance as of December 31, 2004, as well as any future contributions to the account the right to which is earned and vested as of December 31, 2004, plus post-2004 earnings on pre-2005 deferrals, as noted above.[333]

For nonaccount balance plans (a nonqualified deferred compensation plan that is not an account balance plan), the grandfathered amount will equal the present value as of December 31, 2004 of the amount to which the employee would be entitled under the plan if the employee voluntarily terminated on December 31, 2004 and received the maximum value available from the plan on the earliest date allowed under the plan.[334]

For the above purposes, a plan has the meaning set forth in Treas. Reg. § 1.409A-1(c) (an agreement, program or other arrangement even if it applies to one participant) but the plan aggregation rules generally do not apply.[335]

Lose Grandfathering if Material Modification After 10/3/04. As stated above, even amounts deferred before January 1, 2005 lose their grandfathered status under § 409A if the plan is materially modified after October 3, 2004.[336] Generally, a material modification occurs if a benefit or

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[330] Treas. Reg. § 1.409A-6(a)(2) [pg. 386].

[331] Treas. Reg. § 1.409A-6(a)(1) [pg. 385].

[332] Treas. Reg. § 1.409A-6(a)(1)(ii) [pg. 386]. See also Notice 2006-79, § 3.05.

[333] Treas. Reg. § 1.409A-6(a)(3)(ii) [pg. 389].

[334] Treas. Reg. § 1.409A-6(a)(3)(i) [pg. 388]. This has the effect of turning the benefit to something akin to a savings plan account balance. The Final Regulations also allow the grandfather to be increased to a benefit actually received.

The grandfathered amount may be increased to equal the benefit the individual actually became entitled to with respect to the period of service prior to 2005. Treas. Reg. § 1.409A-6(a)(3)(i) [pg. 388]. Additional assumptions and materials that were reasonable to use as of December 31, 2004 may continue to be used in subsequent years for determining the grandfathered amount. Id.

[335] Treas. Reg. § 1.409A-6(a)(3)(v) [pg. 391].

[336] AJCA § 885(d)(2)(B); Treas. Reg. § 1.409A-6(a)(1) [pg. 385].

right existing as of October 3, 2004 is materially enhanced or a new material benefit or right is added (which affects amounts earned and vested before 2005).[337]

A material modification would also occur if an employer exercised its discretion to accelerate vesting of a plan to a date before 2005. However, it is not a material modification to exercise discretion over time and form of payment as permitted under the plan as in effect on October 3, 2004.[338]

A reduction of an existing benefit (e.g., removal of a haircut provision) is not a material modification.[339]

Amendments to conform the plan to the requirements of § 409A, for deferrals occurring after 2004 is not a material modification with respect to amounts earned and vested before 2005. A cessation of deferrals or termination of a plan pursuant to the terms of such plan is not a material modification.[340]

There are other modification rules regarding establishment of a rabbi trust, cancellation of deferral when not violating 409A, compliance with domestic relations orders, modification of life annuities, addition of limited cashouts, or changing notional investment measures.[341]

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337 Treas. Reg. § 1.409A-6(a)(4)(i) [pg. 391]; Conf. Rep.

Such material benefit enhancement or addition could occur pursuant to an amendment or the employer's exercise of discretion under the plan. Id.

For example, adding a provision that payments of amounts earned and vested before 2005 may be allowed if there is a 20% haircut, would be a material modification. Taking away a benefit is generally not a material modification, as discussed below

If a plan is materially modified with additional rights, the whole plan would lose its grandfather treatment. (Hogans, Webcast ASPPA 6/4/07.)

338 Treas. Reg. § 1.409A-6(a)(4)(i) [pg. 391-392]. Also, it is not a material modification for an employee to exercise a right permitted under the plan as in effect on October 3, 2004. Id.

The amendment of a plan to bring the plan into compliance with the provisions of § 409A will not be treated as a material modification.

Treas. Reg. § 1.409A-6(a)(4)(i) [pg. 392]; Conf. Rep. However, an amendment or exercise of discretion under the plan that materially enhances an existing benefit or adding a new material benefit will be a material modification even if the enhanced or added benefit would be permitted under Section 409A. For example, adding the right to payment on an unforeseen emergency of an amount earned and vested before 2005 would be a material modification. Treas. Reg. § 1.409A-6(a)(4)(i) [pg. 392].

339 Treas. Reg. § 1.409A-6(a)(i) [pg. 392]; Conf. Rep. (2004).

340 Treas. Reg. § 1.409A-6(a)(4)(iii) [pg. 395].

341 The establishment or contribution to a rabbi trust is not a material modification, provided there is no other modification. Treas. Reg. § 1.409A-6(a)(4)(i)(A) [pg. 392].

Modification of a provision requiring immediate cancellation of the current deferral election, to require cancellation of deferrals for the same period of time beginning when such cancellation would not violate

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To the extent a modification is rescinded before the earlier of the date any additional right granted under the modification is exercised or by the end of the calendar year in which the modification was made, the modification will not be treated as a material modification of the plan.[342]

The regulations provide that the plan aggregation rules of Treas. Reg. § 1.409A-1(c)(2) do not apply to the modification restrictions of Treas. Reg. § 1.409A-6(a)(4).[343]

Q&A 19(c) Elections and Grandfathering. As discussed below, under Notice 2005-1, Q&A 19(c), and Notice 2007-86, § 3.01(B)(1).02, a plan can be amended on or prior to December 31, 2008, to provide for new payment elections without violating subsequent deferral or anti-acceleration rules, provided that amounts payable after 2008 not be made payable prior to 2009 and amounts payable prior to 2009 not be made payable after 2008. It would appear that a Q&A 19(c) amendment is a modification of the plan as a material benefit, but nevertheless since plan aggregation rules do not apply, a year by year analysis could be utilized, such that the year of payments for which a Q&A 19(c) election is made would not be able to utilize the grandfather, but deferrals for other years for which no Q&A 19(c) election is made can utilize grandfathering.

Grandfathered Discounted Stock Options and SARs and Modification. Stock options, SARs and similar rights that would otherwise be subject to § 409A, e.g., discounted stock options, will be treated as earned and vested by December 31, 2004 and thus grandfathered, if by such date the right was either immediately exercisable for cash or substantially vested (as defined in Treas. Reg. § 1.83-3(b)).[344]

The material modification rules for grandfathered equity-based compensation are similar to the material modification rules for purposes of stock rights covered under § 409A. A modification,

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Section 409A (e.g. the beginning of the first taxable year following cancellation) would not be a material modification. Treas. Reg. § 1.409A-6(a)(4)(i)(B) [pg. 393].

Compliance with a domestic relations order will generally not be a material modification. Treas. Reg. § 1.409A-6(a)(4)(i)(C), [pg. 393]. Modification of a plan with a life annuity form to permit another form of annuity that would be treated as a single form of payment under the subsequent election rule of § 1.409A-2(b)(2)(i) is not a material modification. Treas. Reg. § 1.409A-6(a)(4)(D) [pg. 393]. The addition of a limited cashout (as permitted in § 1.409A-3(j)(4)(v) (as an exception to the prohibition on accelerated payments) is not a material modification. Treas. Reg. § 1.409A-6(a)(4)(i)(E) [pg. 393].

It is not a material modification to change a notional investment measure to, or to add an investment measure that qualifies as a predetermined actual investment within the meaning of Treas. Reg. § 31.3121(v)(2)-1(d)(2). Treas. Reg. § 1.409A-6(a)(4)(iv) [pg. 395].

342 Treas. Reg. § 1.409A-6(a)(4)(vi) [pg. 396].

343 Treas. Reg. § 1.409A-6(a)(4)(vii) [pg. 397].

344 Treas. Reg. § 1.409A-6(a)(2) [pg. 387]. Accordingly, stock options that on or before December 31, 2004, were immediately exercisable for substantially vested stock would not be subject to § 409A, but if it was exercisable only for nonvested stock it would be subject to § 409A.

See Notice 2006-4 that for options outstanding at December 31, 2004 and not altered thereafter, fair market value can be determined using the same good faith method that applies to incentive stock options under Treas. Reg. § 1.422(e)(1), but for options that become exercisable or are modified after 2004, the valuation set forth in Notice 2005-1 and in Treas. Reg. § 1.409A-1(b)(5) will apply.

extension or renewal of a stock right will not be considered a material modification unless it is treated as a regrant under § 1.409A-1(b)(5)(v).[345] Adoption of new plan, or grant of an additional benefit under a plan between October 3, 2004 and December 31, 2004 is a material modification unless the grant is consistent with historical compensation practices.[346] The material modification rule may require that the options be granted by October 3, 2004, and it is not sufficient to merely be vested by December 31, 2004.[347]

For equity-based compensation plans subject to § 409A, for grandfathering purposes such plans are treated like account balance plan (grandfathered for vested account balance as of December 31, 2004), except that the account balance is deemed to be the amount of the payment available to the employee on December 31, 2004 (or that would be available if the right were immediately exercisable), the right to which is earned and vested as of December 31, 2004.[348]

When to Maintain Grandfathering. In order to preserve grandfathered status, many employers have frozen grandfathered plans and set up new § 409A plans going forward, while other employers have grandfathered treatment set forth in the ongoing plan. Many employers choose not to utilize grandfathering in order to simplify administration, particularly if the pre-2005 plan distribution rules are not made more liberal than the 409A rules, or if only a small percentage of pre-targets or benefit is affected.

Under Notice 2007-86, a plan adopted before December 31, 2008 will not violate § 409A if the plan is operated in good faith compliance with § 409A and with Notice 2005-1 or the Final Regulations, and the plan is amended on or before December 31, 2008 to conform to the provisions of § 409A.[349]

Change in Payment Elections or Conditions by 12/31/08; Cannot Delay Payments from Transition Year to Later Year or Accelerate to Earlier Year. For amounts subject to § 409A, a plan could be amended to provide for new payment elections without violating the subsequent deferral and anti-acceleration rules, provided that the plan was amended and the participant made the election on or before

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[345] Treas. Reg. § 1.409A-6(a)(4)(v) [pg. 395]. It will also not be treated as having a deferral feature.

[346] Treas. Reg. § 1.409A-6(a)(4)(ii) [pg. 394].

[347] Id. The adoption of a new plan or grant of an additional benefit after 10/3/04 is presumed to be a material modification after 10/3/04 under Treas. Reg. § 1.409A-6(a)(4)(ii) [pg. 393], which would cause the arrangements to lose grandfathering treatment.

[348] Treas. Reg. § 1.409A-6(a)(3)(iii) [pg. 389].

[349] Notice 2007-86, 2007-46 I.R.B. 990, § 3.01(B)(1).01. See also Preamble to Proposed Regulations, 70 Fed. Reg. at 57954; Notice 2005-1, Q&A 19, with the original December 31, 2005 deadline extended to December 31, 2006 by Preamble to Proposed Regulations, to December 31, 2007 by Notice 2006-79 and to December 31, 2008 by Notice 2007-86. See also, Treas. Reg. § 1.409A-1(c)(3)(vii) [pg. 258]. (Interim relief in Notice 2007-78 was superseded by Notice 2007-86.)

For periods after December 31, 2007 and before January 1, 2009, compliance with the Final Regulations (but not Proposed Regulations) would be good faith compliance.

See ABA JCEB Q&As for IRS (2008) Q&A 34 that even if a plan document is too broad, e.g., the plan change in control definition is more expansive than the 409A change in control definition, good faith compliance prior to January 1, 2009 will be met as long as in operation the employer follows the 409A rules and not the plan rules.

December 31, 2008.[350] An employee cannot change payment elections in 2008 to delay payments the employee would otherwise receive in 2008 to a later year, or to accelerate payments that were to be paid after 2008 and pay them in 2008.[351] The same is true for 2007 and 2006.[352] For example, an agreement with deferred compensation payable in 2008 could not be amended under this transition rule to be payable in a later year, and if payable in 2009 or later it could not be amended to become payable in 2008 (and the same example would be true for 2007 and 2006).

Other Expired Transition Rules. Notice 2005-1 provides that for deferrals of amounts for service performed on or before December 31, 2005, if elections were made on or before March 15, 2005 the initial deferral timing requirements under § 409A(a)(4)(B) would not apply, provided certain requirements were met.[353]

A plan must have been amended by December 31, 2005, to terminate participation in the plan or cancel a deferral election without becoming subject to § 409A, provided the amounts were includible in income in 2005 or in the year vested.[354]

Amending an arrangement on or before December 31, 2005, to terminate the arrangement and distribute the amounts of deferred compensation will not have been a material modification, provided that all amounts deferred under the plan are included in income in the year of termination.[355]

Transition Relief for Linked Plan Elections by 12/31/08. For periods ending on or before December 31, 2008, a payment election under a nonqualified deferred compensation plan that is controlled by the election made under a qualified plan (or made under 403(b) annuities, 457(b) plans or certain foreign broad-based plans) will not violate § 409A, provided the determination of time and form

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[350] Notice 2007-86, § 3.01(B)(1).02. See also Notice 2005-1, Q&A 19(c), with the original December 31, 2005 deadline extended to December 31, 2006 by Preamble to Proposed Regulations, Section XI.C to December 31, 2007 by Notice 2006-79, § 3.02 and to December 31, 2008 by Notice 2007-86. Note that Notice 2006-79 § 3.02 and Notice 2007-86, § 3.01(B)(1).02 clarify that this exception applies to elections by either the employee or the employer.

It is not clear if Notice 2005-1 Q&A 19(c) reliance would help for arrangements where deferrals for one year have had changes in elections and deferrals for other years have not.

[351] Notice 2007-86, § 3.01(B)(1).02. Thus, a plan can provide for new payment elections to be made in 2008, provided the plan is so amended and the employee makes applicable election by December 31, 2008, and the amendment and election applies only to amounts that would not otherwise be payable in 2008 and does not cause an amount to be paid in 2008 that would not otherwise be payable in such year.

[352] Notice 2007-86, § 3.01(B)(1).02. See also, Preamble to Proposed Regulations, 70 Fed. Reg. at 57954-5.

[353] Notice 2005-1, Q&A 21. No extension is provided for initial elections under the Preamble to the Proposed Regulations. The deadline of the plan amendment to reflect this relief is December 31, 2008 (but with the burden on the taxpayers to show the deferral election was made by March 15, 2005). See Notice 2007-86, § 3.01(B)(2).06.

[354] Notice 2005-1, Q&A 20(a). No extension is provided termination of participation in plan or cancellation of deferrals by the Preamble to the Proposed Regulations, because the relief was intended as a temporary period during which employees could decide whether to continue to participate in an arrangement subject to § 409A.

[355] Notice 2005-1, Q&A 18(c). The relief provided in Notice 2005-1, Q&A 18(c) is not extended by Preamble to Proposed Regulations or by the Notices.

of payment is made in accordance with the terms of the deferred compensation plan as of October 3, 2004.[356]

Substitutions of Discounted Options and SARs With Non-discounted Options and SARs. It will not be a material modification to replace a stock option or SAR otherwise providing for a deferral of compensation under § 409A with a stock option or SAR that would not have constituted a deferral of compensation under § 409A if it had been granted on the original date of grant of the replaced stock option or SAR, provided the cancellation and reissuance occurred on or before December 31, 2005.[357] In addition, the period during which the cancellation and reissuance may occur is extended by the Proposed Regulations to December 31, 2006, but only to the extent such cancellation and reissuance does not result in the cancellation of a deferral in exchange for cash or vested property in 2006.[358] Furthermore, the period during which the cancellation and reissuance may occur was further extended by Notice 2006-79 and Notice 2007-86 to December 31, 2008, but only to the extent such cancellation and reissuance in 2007 or 2008 does not result in the cancellation of a deferral in exchange for cash or vested property in 2007 or 2008, and such cancellation and reissuance in 2008 does not result in the cancellation of a deferral in exchange for cash on vested property in 2008, and such extension to December 31, 2008 does not apply to public companies required to restate earnings because of backdated options granted to § 16 insiders.[359] Thus, a replacement with non-discounted options or stock must have occurred in 2005 if the employer will compensate the holders for the elimination of the discount with vested stock or cash, but can be done in 2006 to 2008 if such amount is non-vested. Another possible solution for a discounted

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356 Notice 2007-86, § 3.01(B)(1)03. See also Notice 2005-1, Q&A 23 with original December 31, 2005 deadline extended to December 31, 2006 by Preamble to Proposed Regulations, to December 31, 2007 by Notice 2006-79 and to December 31, 2008 by Notice 2007-86.

Notice 2006-79 cautions that other provisions of the Code and common law tax doctrines continue to apply to any election as to the time and form of payment under a nonqualified deferred compensation plan. There is some concern that SERPs with linked elections even if grandfathered as of 12/31/08 may still have constructive receipt issues if participant can retire from the qualified plan at any time. Also if the payment is on separation from service it may be subject to the six-month delay. However, IRS officials have stated that the transition rule would allow linked plans to make payments under linked elections and the six-month delay would not apply.

357 Notice 2005-1, Q&A 18(d).

358 Notice 2005-1, Q&A 18(d), as extended by Preamble to Proposed Regulations. The restriction on receiving cash or vested property is similar to accelerating receipt of property to an earlier year prohibited, as noted above.

359 Notice 2006-79, § 3.04 and Notice 2007-68, § 3.01(B)(1).04. Thus, a discounted option generally may be replaced through December 31, 2008 with an option that would not have provided for a deferral of compensation, although the exercise of such a discounted option in 2008 before the cancellation and replacement generally would result in a violation of § 409A. Where replacement stock options or SARs that would not constitute deferred compensation subject to § 409A are issued in accordance with the conditions set forth above, such replaced award would be treated for purposes of § 409A as if granted on the grant date of the original award. Notice 2007-68, § 3.01(B)(1).03, Notice 2006-79, § 3.04 and Preamble to Proposed Regulations.

If there is compensation for loss of discount for conversion in 2008, the compensation cannot vest in 2008 and must vest in 2009 or later.

Converting a discounted option to cash in a transaction may cause impermissible acceleration of payment to 2006, 2007 or 2008.

option that vested after 2004 is to convert it to a § 409A compliant plan by having the option be exercisable on a fixed exercise date in the future (perhaps accelerated for change in control) as permitted under § 409A(a)(2), as discussed above.[360]

J. Restrictions on Foreign or Springing Rabbi Trusts

Offshore Rabbi Trusts. Assets set aside in an offshore rabbi trust for the purpose of paying deferred compensation are treated as § 83 compensatory transfers (i.e., taxed when vested) at the time they are set aside or transferred outside the U.S.[361]

Financial Health Triggers. Assets are treated as transferred for purposes of § 83 (i.e. taxed when vested) at the time that (i) if a deferred compensation plan provides that assets will become restricted to the provision of benefits under the plan if the employer's financial health changes, or (ii) the assets are so restricted.[362]

Income Inclusion for Offshore Trusts and Financial Health Triggers. Increases in income of, and earnings on such assets of offshore rabbi trusts and employer's financial health triggers are treated as additional § 83 transfers.[363] However, this rule does not apply to trust assets located in a foreign jurisdiction if substantially all of the services to which the deferred compensation relates are performed in that foreign jurisdiction. The tax is increased by interest at the underpayment rate plus one percent from the time of original deferral or vesting as well as an additional tax equal to 20% of the amount included in income.[364]

Effective Date. These rules are effective for amounts deferred after December 31, 2004.[365]

Restriction on Funding Nonqualified Deferred Compensation Plan if Have Severely Underfunded or Terminating Defined Benefit Plan. The Pension Protection Act of 2006 adds Code §

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360 See IRS Announcement 2007-18 which provided a compliance resolution program though Feb. 28, 2007 to pay additional taxes under Code § 409A due to exercise of discounted options and SARs in 2006.

361 Code § 409A(b)(1).

362 Code § 409A(b)(2).

363 Code § 409A(b)(3).

364 Code § 409A(b)(4). The regulations reserve treatment of funding arrangements for future guidance.

365 AJCA § 885(d) provides that Code § 409A applies to amounts deferred after December 31, 2004. Section 885(d) also provides that § 409A applies to earnings on deferred compensation only to the extent that § 409A would apply to the deferred compensation. Section 403(hh)(3)(A) of the Gulf Opportunity Zone Act of 2005 ("GOZA") provides that the effective date of the provisions relating to offshore trusts and financial health triggers is January 1, 2005, including amounts set aside or restricted with respect to deferrals of compensation that were earned and vested on or before December 31, 2004. IRS Notice 2006-33 provides that, until further guidance is issued on § 409A(b), taxpayers may rely on a reasonable, good faith interpretation of § 409A(b). Notice 2006-33 also provides that, with respect to assets set aside, transferred or restricted on or before March 21, 2006, so as to be subject to inclusion under § 409A(b)(1) or (2), taxpayers shall be treated as not having triggered the inclusion or additional tax provisions of § 409A(b) if the nonqualified deferred compensation plan comes into conformity on or before December 31, 2007, with the requirements of section 409A(b) and any guidance issued before such date.

409A(b)(3), which provides that if the employer or controlled group member (i) has a severely underfunded plan (less than 60% funded), (ii) is in bankruptcy, or (iii) has within six months terminated a pension plan in a distress termination, then assets may not be set aside in a so-called rabbi trust to pay deferred compensation of senior executives. Code § 409A(b)(3). If assets are set aside in the trust they will be considered immediately taxable to the participants and will be subject to additional 20% tax and interest penalties. Id. If there are gross-ups to cover such penalties of the executives, such gross-ups will be nondeductible and will be subject to income tax and 20% tax and penalties. Code § 409A(b)(3)(C). These provisions are effective August 17, 2006.[366]

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[366] Pension Protection Act of 2006 § 116(c).