The New Deferred

Could ERISA and tax lawyers finally be getting cool and popular?

No, of course not. However, the IRS' final guidance on tax code Section 409A has filled many a dance card for tax and benefits lawyers. They have been "must-have" speakers at legal and professional conferences, and their colleagues in other practice areas have been lining up with the same question: "Is this okay under Section 409A?" In April 2007, after a few years of interim guidance and transition rules, the IRS issued long-awaited final regulatory guidance on Section 409A. At 397 pages, however, it is fair to say that the IRS's final guidance raised nearly as many questions as it has answered.

For many in-house lawyers, Section 409A's broad concepts and myriad exemptions and exceptions make knowing whether you have a Section 409A issue half the battle. Section 409A issues pop up in numerous pay arrangements—from complex change-in-control provisions and retention incentives to routine offer letters and separation agreements. Traps for the unwary exist in annual bonus programs, retiree medical, discounted stock options, change in control payments, and a host of other types of compensation. Although we have had the benefit of final IRS guidance since April 2007, it may still be some time before all the ins and outs of Section 409A are clear even to the experts. Nonetheless, as an in-house attorney, you should be familiar enough with Section 409A to spot the arrangements that implicate it. The goal of this article is to give you a crash course in issue-spotting so that you can call in the experts when you really need them.

Compensation Rules:

AN ISSUE-SPOTTER'S GUIDE TO TAX CODE SECTION 409A

By Jim Murphy and Matt Renaud

What Is Section 409A Intended to Regulate?

To spot a Section 409A issue, it is helpful to understand what it was designed to do. In large part, it is intended to regulate how executives and their employers are able to move taxable income from one year to another year to reduce or postpone tax exposure. A classic illustration is a salary deferral program or a bonus that an executive wishes to defer until a subsequent year. Another illustration—the flip side of the coin—is a benefit or payment that "may be accelerated at the discretion of the company." Both arrangements permit the employer and the employee to manipulate the year in which the income is taxed. Section 409A does not prevent deferred compensation, but it does regulate it by curbing the ability to manipulate the timing of income recognition once the arrangement is in place, and by requiring additional structure to arrangements that have typically been somewhat relaxed in practice and structure.

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Why Should I Care About Section 409A?

Practically speaking, if you have any responsibilities for employment agreements, bonuses, or compensation plans, you will need to care about Section 409A if you want to keep your job. Section 409A imposes a 20 percent excise tax (and other negative tax effects) on any individual benefiting under a nonqualified deferred compensation arrangement that does not comply with Section 409A's byzantine set of rules. That individual could be your CEO, a member of your board of directors, or someone else with a say in your tenure or compensation. Need we say more?

What Is "Nonqualified Deferred Compensation?"

Section 409A applies to "nonqualified deferred compensation." This term is defined as any plan or arrangement where a service provider has a legally binding right during a taxable year to compensation that, pursuant to its terms, is or may be payable to (or on behalf of) the service provider in a later year. This definition raises some additional questions: What is a "legally binding right," and what or who is a "service provider?"

A "legally binding right" means that there is a legally enforceable right to payment, either by contract or other legal right. The benefit does not have to be vested (i.e., the benefit can be, and, often is, subject to a substantial risk of forfeiture. For example, an employment offer letter outlining 12 months of severance if the employee is terminated without cause during a five-year period will constitute a legally binding right to the severance payment. Of course, the severance may never be paid (if she's never terminated or she quits during the term), but it does constitute a legally binding right.

Section 409A applies to "service providers" working for "service recipients." A service provider is an employee, director, or leased employee, and also includes an independent contractor working substantially for one employer. Partners in a partnership and members of limited liability companies (LLCs) who provide services to their entities are also considered service providers for purposes of Section 409A. Section 409A is not limited to executives, insiders, or highly compensated service providers, although a good number of rank-and-file benefit arrangements are usually exempt in one way or another.

How Do I Know if Section 409A Applies?

To answer this question accurately, you have to follow some analytical steps. First, does the arrangement constitute "nonqualified deferred compensation?" If it does, you next need to determine whether the arrangement is somehow exempted from Section 409A on grounds that it is: (a) "grandfathered," (b) excluded from Section 409A by regulation, or (c) falls within one of the exceptions to Section 409A. If you determine that none of these exemptions applies, you have a Section 409A covered arrangement. That's not the end of the world, though. All that means is that the arrangement must follow the rules of Section 409A, including that it be put in writing, and payment can be made only upon the occurrence of one of the Section 409A specified events: death, disability, change in control, separation from service, or upon a specified payment date.

Some examples of arrangements that are susceptible to Section 409A might help. While traditional deferred compensation plans for executives are covered by Section 409A, other less obvious compensation arrangements could be subject as well. Possibilities include:

- annual bonus plans,
- individual employment and severance agreements,
- retention agreements or programs,
- severance plans or policies,
- separation arrangements, including those in which employees are kept on payroll as a form of severance,
- equity plans (options, restricted stock, phantom stock, etc.),
  - plain vanilla stock options granted at fair market value and shares of restricted stock are not considered nonqualified deferred compensation,

- discounted stock options and restricted stock units are subject to Section 409A (Note: issuing stock options in a non-publicly traded company raises valuation issues under the IRS final regulations),
- change-in-control benefits, or
- post-employment expense reimbursement arrangements.

What Does Section 409A Require?

To comply with Section 409A, a deferred compensation arrangement must satisfy the following basic rules:

- The plan must be in writing.
- Deferral elections (if any) must be made in advance of the year in which the compensation is earned.
- The time and form of payment must be determined up front (i.e., when the arrangement is first put in place) and can be changed only under limited circumstances.
- Payments can be made only upon death, disability, separation from service, change in control, or a specified payment date.
- Payments cannot be accelerated by the employer or by the employee.
- Assets dedicated to funding benefits (such as in a rabbi trust) cannot be maintained offshore.
- Post-employment expense reimbursement must be limited to a specified period (which can include for life) and unused amounts cannot roll over from year to year.
- Trust or other assets securing a Section 409A arrangement cannot be held offshore and the setting aside of assets cannot be triggered by financial conditions (eliminates "springing" trusts).

There are many variations on how and when these basic rules apply, but four of the most significant rules that you should know about include the following:

- *Six-Month Delay for Specified Employees*: For "specified employees" of a publicly traded company, Section 409A benefits payable on account of a "separation from service" (*see below*) cannot be made within six months of that separation from service. Specified employees are "key employees" defined under the qualified plan "top heavy" rules, and generally include the 50 most highly-paid officers of the company. The IRS final regulations provide guidance on how to determine specified employees for a given period of time and permit methods under which the delay can be applied to more than the top 50 officers so that employers can ensure that they include all necessary specified employees.
- *"Separation from Service:"* Section 409A requires a functional definition of "separation from service," which is the most common payment trigger. A separation from service means death or termination of employment, but termination of employment is determined based on a facts-and-circumstances analysis and generally means the point at which substantially no services are provided or expected to be provided. The regulations create some rebuttable presumptions, but you generally want to avoid continuing to treat people as employees as a form of severance (i.e., payroll continuation practices) and you also need to be careful when bringing a retiree or former employee back as a non-payrolled consultant or advisor.
- *Aggregation:* Like arrangements are aggregated and treated as a single plan for most Section 409A purposes, which will often affect your analysis. See Quick Quiz 5 for an example of how aggregation applies.

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Webcasts

The Wait Is Over—Facing the Final 409A Regulations. Presented by ACC's Corporate & Securities Law Committee, sponsored by Kilpatrick Stockton LLP. The final 409A regulations address important questions left unanswered by the proposed regulations released in 2005, and they include key revisions and refinements. The webcast explains: how to comply with the section 409A's documentation requirement; what to do with good-faith positions that extend beyond December 31, 2007; the liberalized rules in key areas, e.g., stock options, severance, reimbursement arrangements, and more; how to deal with key problem areas, including employment agreements, plans distinguishing between different separations from service, and payments tied to recovery from disability; and strategies for the final months of the transition period. Read the webcast transcript at *www.acc.com/resource/v8433*; and listen to the original recording at *www.acc.com/resource/v8363.*

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- *Substitution of Benefits:* If you cancel or forfeit a benefit and replace it with another benefit, that substitute benefit will be subject to the same time and form of payment terms that applied to the original benefit.

While compliance does not have to be difficult, the more unique your compensation arrangement is, the more likely it will require a number of twists and turns to fit within the new Section 409A rules. Simpler executive arrangements will be, perhaps, the one happy by-product of Section 409A.

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What Are the Exemptions to Avoid Application of Section 409A?

Exemptions to avoid Section 409A will likely apply to most of your company's deferred compensation plans that are bonus and severance arrangements. Exemptions fall into three broad categories: grandfathered benefits, tax-exempt benefits, and regulatory exemptions.

- *Grandfathered Benefits*. Grandfathered benefits are those benefits that were around before Section 409A was enacted. To be precise, grandfathered benefits are nonqualified deferred compensation arrangements (written and unwritten) that were (1) in place on or before October 3, 2004, and (2) earned and vested as of December 31, 2004. Any material modification of such a benefit will ruin its grandfathered status and subject it to Section 409A.
- *Tax-Favored Benefits*. Tax-favored benefits and paid-time-off programs are also not considered nonqualified deferred compensation. Generally, these programs include: qualified retirement plans; generally available retiree medical, dental, and prescription drug benefit plans; STD, LTD, and AD&D plans; life insurance plans (but some forms of split-dollar are covered); medical and dependent care spending accounts; vacation leave/pay; and sick leave/pay.
- *Short-Term Deferral Exemption*. The most important and useful regulatory exemption is the short-term deferral exemption. Compensation is exempt from Section 409A if (1) the arrangement contains no deferral feature and (2) it is paid within two and a half months of the end of the year in which the compensation is no longer subject to a substantial risk of forfeiture. Whether an arrangement has a deferral feature can often be difficult to determine at first blush, but generally means that the plan does not affirmatively permit a payment date that is later than March 15 of the year following the vesting year.

Other Section 409A Exemptions

The 2X/2Y exemptions. Most severance payments will be exempt under a fairly broad exemption. The 2X/2Y exemption applies to arrangements that fall within the following parameters:

- an involuntary termination or termination for "good reason" as defined in the regulations;
- if termination is voluntary, the arrangement must meet requirements of a "window benefit" as outlined in the regulations;
- "2X" refers to the amount of severance provided. To meet the exemption, the payment cannot exceed the lesser of (1) two times the individual's annual compensation, and (2) two times the Code Section 401(a)(17) annual compensation limit for the prior year (i.e., 2 x $225,000 for 2008); and
- "2Y" refers to the timing requirement—all severance payments must be made by the end of the second taxable year following the year in which the separation from service occurs.

Note that if a portion of the payment satisfies the 2X/2Y requirements, then that portion would still be exempt while the remainder would be subject to Section 409A.

There is an exemption for "de minimis" payments. This exemption applies if the amount of the payment is less than the 401(k) annual contribution limit for the prior year, which is $15,500 for 2008.

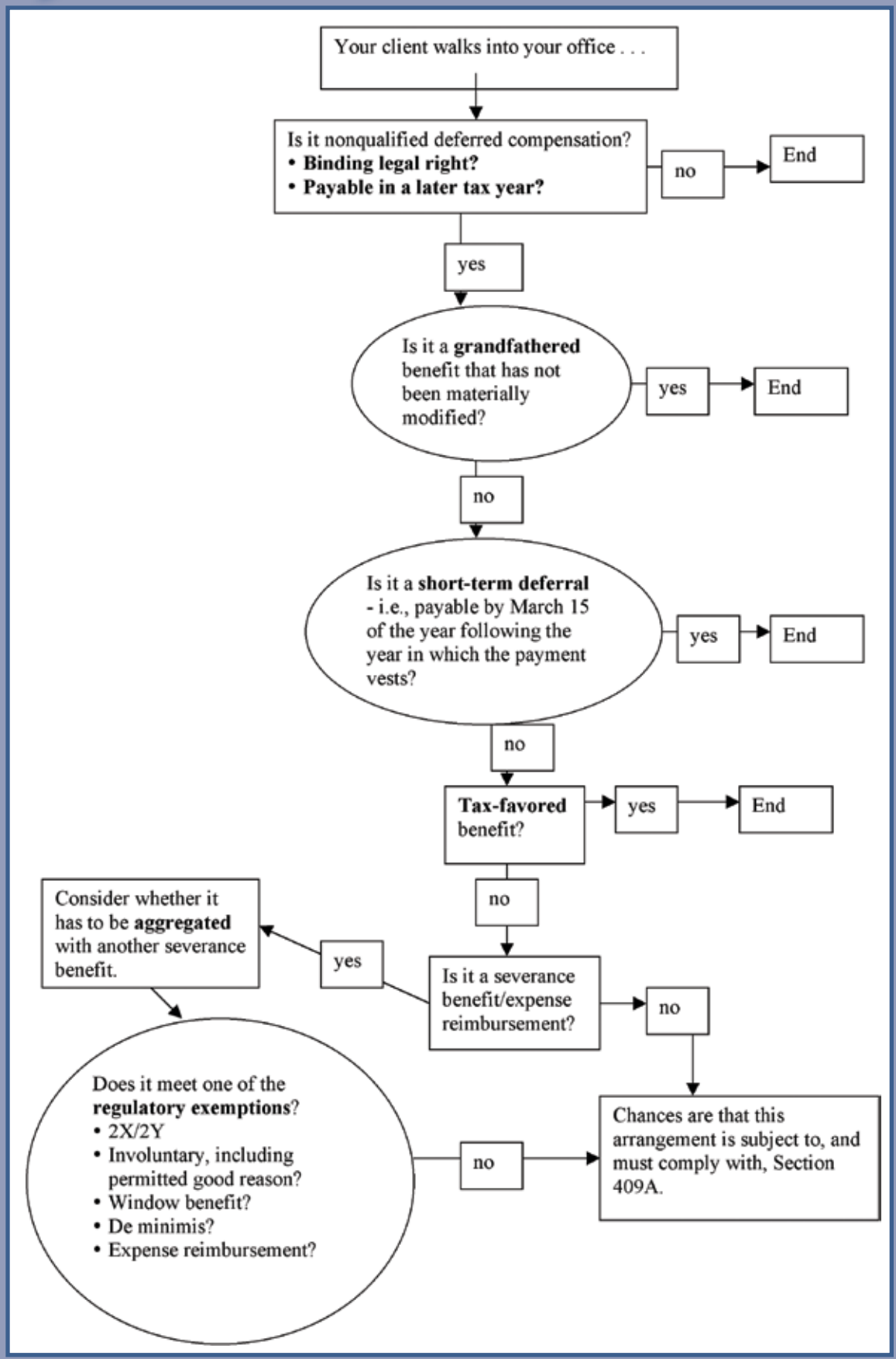
Post-employment expense reimbursements following voluntary or involuntary termination are generally exempt from Code Section 409A if they are made by the end of the second taxable year following the year in which the separation from service occurs.

To the extent that post-employment benefits and expense reimbursements are not taxable to the service provider, they are exempt from Section 409A.

The chart on the following page can be used to sort through Section 409A issues when dealing with non-traditional forms of deferred compensation—e.g., severance, bonus plans, and expense reimbursement.

The following hypothetical situations will illustrate some of the more common Section 409A issues and how they might be resolved.

Sorting Through Section 409A



Section 409A QUICK QUIZ #1: The Offer Letter

Your VP of HR copies you on his latest hiring offer letter. In it, he assures the candidate that if he isn't promoted into a senior management role within one year, he can quit anytime thereafter and trigger severance. Trouble? The letter also assures the prospect, currently residing in the United Kingdom, that the company will pay for first-class airfare for him and his family to return to the United Kingdom if the job doesn't work out. More trouble?

Yes and yes. While a number of exemptions to Section 409A might apply, severance paid for a voluntary termination should always raise a red flag and receive extra attention. Such a provision gives the employee discretion as to when to pull the severance card and thereby manipulate the year in which the severance income is taxed. The final Section 409A regulations do contain a "good reason" termination concept that is useful and might apply here if the agreement is properly designed. As always, try to design the arrangement to be exempt:

1. Short-term deferral
   - Payable upon involuntary (otherwise it's considered vested when entered into) or "good reason" termination. If it can be triggered voluntarily (without "good reason"), it's considered vested and therefore not eligible for short-term deferral treatment.
   - The Section 409A regulations define "good reason" and impose a number of timing and notice restrictions. But generally, if being promoted was a material term of his employment agreement, his voluntary termination could be a "good reason" termination.
   - Paid by March 15 of the year following the vesting year.
2. 2X/2Y
   - Could meet this exemption if an involuntary or "good reason" termination.
   - Could also meet the window version of the 2X/2Y exemption if there is a 12-month time limit put on his right to quit.
   - The offer letter should incorporate the exemption 2X/2Y payment and timing rules.

With respect to the first-class airfare, post-employment expense reimbursements are generally subject to Section 409A, but careful drafting can ensure compliance or exemption. Such expenses should be incurred by the second taxable year following the termination year, and reimbursed by the third taxable year following the termination year.

This example illustrates why management needs to be educated on the new deferred compensation paradigm and why corporate counsel ought to be reviewing any variations from pre-approved form offer letters—at least for the foreseeable future.

Section 409A QUICK QUIZ #2: The Separation Agreement

Your CEO tells you one of the subsidiary executives is leaving and you need to document a severance package which would give him severance benefits of an 18-month salary continuation, permit him to "retire" at the end of the 18-month period, pro-rate his bonus for this year, and permit previously granted restricted stock to vest through the end of the 18-month salary extension period. Trouble?

Yes. While you can accomplish most or all of this, there are a number of traps for the unwary in this scenario. Again, you wouldn't want your CEO to commit to a package without first running all of the Section 409A issues to ground.

1. If this is a publicly traded company, Section 409A payments to a "specified employee" must be delayed for six months. This can be a problem with separation agreements that executives have not adequately planned for in advance. But, even if the six-month delay is required, a portion of nearly any severance can be structured so that it is paid immediately under one or another of the severance plan exemptions. For example, the first $450,000 could be paid during any six-month delay period pursuant to the 2X/2Y exemption if its requirements are met. Even though the total benefit might exceed this amount, the exemption applies to all but the excess amount.
2. Exemptions: Because this is a new agreement, the short-term deferral exemption is available so long as the severance is paid in a lump sum prior to March 15 of the following year. Also, either the involuntary or window 2X/2Y exemption may be possible for at least a portion of the benefit.
3. If the bonus program is fully discretionary, then that plan may not have any Section 409A language attached to it because, by its very nature, no legally binding right attaches to it until it is paid. However, in this situation, the company has committed to paying this bonus, which creates the possibility of deferred compensation subject to Section 409A if it isn't paid by March 15 of the subsequent year. Requiring that payment by March 15 generally cures that issue.
4. Generally, restricted stock is exempt from Section 409A and accelerating the vesting is not a problem, even if the vesting results in early payment of the award. If, however, the "restricted stock" is really restricted stock units (i.e., phantom shares), Section

409A would apply, and while the accelerated vesting is okay, the units could not be paid until their original vesting date.

5. One thing to approach carefully is handling the 18-month payroll continuation arrangement in circumstances in which the executive ceased to perform any services. Because of Section 409A and its "separation from service" definition, there is the potential for significant incongruity between qualified and nonqualified benefits. Applying the functional "separation from service" definition, nonqualified retirement benefits likely would be triggered at the point at which the executive stopped coming to work (perhaps subject to the six-month delay for specified employees). However, the qualified retirement benefit would not commence until the employee subsequently retires under the terms of the qualified plan. This type of arrangement can also create qualified plan, non-discrimination testing issues.

Post-Employment Expense Reimbursements and In-Kind Benefits

Exemptions

- Non-taxable medical benefits,
- Expense reimbursements for terminations (voluntary and involuntary):
  - Applies to taxable benefits that are otherwise deductible as business expenses
  - Applies to reasonable moving and outplacement expenses
  - Expenses incurred through December 31 of the second calendar year following the calendar year in which the termination occurs
  - Reimbursements made by the end of the third calendar year following the year in which termination occurs, and
  - Rollover of unused amounts permissible.

- Retiree medical:
  - Non-taxable medical is exempt from Section 409A,
  - Taxable medical (self-insured plan that is discriminatory in favor of highly compensated employees),
  - Exempt from Section 409A during the COBRA period (as if had COBRA been elected),
  - Reimbursed in the year following the year in which the expenses are incurred, and
  - Other "bells and whistles" may be required.

Compliance with Section 409A

- Objectively determinable benefits,
- Objectively determinable period that the plan applies to (e.g., five years, lifetime, etc.),
- Reimbursements made by the end of the year following the year in which the expense is incurred,
- Reimbursements/in-kind benefits in one year may not affect another year (no rollover of unused amounts from one year to another), and
- The plan rights cannot be exchangeable for cash or another right.

Section 409A QUICK QUIZ #3: Accelerating Payments at Retirement

Your long-serving CFO is finally retiring. He'd like to buy that boat he's always wanted, but he's not ready to cash out his company stock. His supplemental executive retirement plan (SERP) allows benefits to be paid over the participant's lifetime as an annuity payment, but he asks the board to pay him out in a single lump sum as a favor. You have available cash and your CEO would like to get the liability off the books. Trouble?

Yes. Generally, acceleration of deferred compensation isn't allowed under Section 409A, even at the sole discretion of the company. However, there are a couple of ways that some or all of the annuity could be cashed out:

1. Is part of the SERP grandfathered? Any portion that was earned and vested as of December 31, 2004 (generally determined as if the CFO had retired on that date), is "grandfathered" and therefore not subject to Section 409A. That grandfathered portion could be cashed out (assuming there's no other bar to that action in the plan). But note that if such action were not available under the SERP already, this action would likely result in a material amendment that would affect the grandfathered status of the SERP.
2. Change in payment election during the transition. During the Section 409A transition period ending on December 31, 2008, the company could allow the CFO to make a lump-sum distribution election. Any election made in 2008 could only be effective in 2009 or later.
3. Although the CFO could be cashed out by terminating the plan, this works under Section 409A only if all plans of the same type maintained by the company are terminated at the same time (application of the aggregation rule) and the company does not maintain that type of plan for five years.

Section 409A QUICK QUIZ #4: The Bonus Plan

Your company pays bonuses each year to senior management for the prior year's performance. You don't have a written plan, but the CEO and the board have tied bonuses to net income in the past several years. Trouble?

Probably not. If the bonuses are purely discretionary and your company never pays a bonus unless the employee is actively employed on the payment date, then there is no deferral of income (there is no binding legal right to payment prior to the year in which payment is made).

Now, suppose the company always pays a bonus to those employees who retired in the prior year. Trouble?

Yes. Even without a written plan, the IRS takes the position that such a practice could rise to the level of a legally binding right (depending on the surrounding facts and circumstances) and that such a payment is vested so long as the employee is retirement-eligible. This issue is easily solved by ensuring that the program fits into the short-term deferral exemption by making bonus payments on or before March 15 of the subsequent year. If the payment cannot be made by that date, the plan—for retirement-eligible participants—will be subject to Section 409A. Compliance is simple in that the plan must be reduced to writing and a payment date must be specified (you can specify the entire year if you want).

The "belt and suspenders" approach to bonus plans is to put them in writing, require participants to be employed on the payment date, and require payment to be made between January 1 and March 15 of the year following the performance year. (Of course, it is advisable to consult state wage payment laws, which can vary with respect to the point at which they deem bonus or commission compensation to be earned.)

Section 409A QUICK QUIZ #5: Pre- and Post-CIC Severance

Your CEO has an agreement providing for 18 months of base salary if he's terminated without cause. He also has a change in control (CIC) agreement providing that if he is terminated without cause, he will receive a lump sum payment equal to three times his salary and bonus. Trouble?

Yes. On its own, the CIC agreement would qualify for a short-term deferral exemption. Pursuant to Section 409A's aggregation rule, however, a portion of the CIC agreement payment (18 months of salary) would be aggregated with the severance agreement. Thus, the lump sum payment of the 18 months of salary under the CIC agreement would be an impermissible acceleration of the 18 months of payments under the severance agreement.

You can avoid this result, however, by making sure that the definition of a CIC in the CIC agreement meets the Section 409A definition of a CIC, and restricting the termination provision to within two years of the Section 409A CIC. This acts as a "wash" of the payment and permits a different payment option (the lump sum).

> Yes. **On its own,** the CIC agreement **would qualify** for a short-term deferral **exemption.**

Transition Period

The effective date of the IRS's final regulations from April 2007 has been postponed until January 1, 2009. Through December 31, 2008, affected arrangements must comply with Section 409A under a "good faith, reasonable interpretation" standard. This means that you are in compliance with Section 409A if you're following the final regulations, or if you're following the IRS transition guidance along with a good faith reasonable interpretation of the statute where IRS transition guidance is silent or ambiguous.

Educate Your Clients

As you read this, your management and human resources clients could be entering into an arrangement subject to Section 409A and not even know it. You can't shadow them 24/7, so it's a good idea to educate them so they know enough to stop and get advice regarding Section 409A implications. Early involvement is critical, because design and compliance must start as soon as there is a legally binding right to the compensation. We hope and expect that within a year or two, when we are all more comfortable with Section 409A, this type of legal hand-holding won't be quite as necessary as it is today.

Section 409A is as complex and reticulated as ERISA. It is a daunting legal framework of complicated and intersecting rules that punish simple and honest errors with significant adverse consequences. Over time, compliance should become routine. For now, you and your management team need to be aware of Section 409A's broad applications and have a coordinated approach so that each of your deferred compensation arrangements can either be clearly exempt or be squarely in compliance with the Section 409A rules. In the short term, this means that management should call you before they enter into any new compensation arrangement or modify any existing arrangement.

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