SELECTED PROVISIONS OF THE FINAL INTERNAL REVENUE CODE SECTION 409A REGULATIONS

By:

John C. Blackman
Jones Walker
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I. INTRODUCTION

A. Nonqualified deferred compensation ("NQDC") plans ("NQDCP") are any arrangements, including individual employment contracts, which defer compensation.

1. Internal Revenue Code ("Code") Section 409A(d)(1) provides that the term NQDCP means any plan that provides for a deferral of compensation.

a. Profoundly unhelpful.

2. According to the regulations, a plan provides for the deferral of compensation if the service provider has a legally binding right during a taxable year to compensation that is or may be payable to or on behalf of the service provider in a later taxable year.

a. A legally binding right to an amount that will be excluded from income when and if received does not constitute a deferral of compensation.

b. A service provider has a legally binding right to compensation in a year if he is entitled to the compensation at a later time for services provided in a service year provided certain conditions are satisfied. The service provider does not have to have a vested right to the compensation in a service year to have a legally binding right to it.

3. Prior to Code Section 409A, service providers and service recipients were free to design NQDCPs any way they wished. The only tax constraint was that they had to be designed so that the service provider was not taxed on the amount deferred prior to the time he had a right to the cash under constructive receipt and similar doctrines.

B. Why did Congress enact Code Section 409A.

1. Primarily because of perceived abuses such as the Enron case. Enron Executives deferred about $150 million in compensation and received about $53 million in accelerated distributions in the weeks before Enron filed for bankruptcy. Those in control who had NQDCPs got theirs while the rank and file employees, creditors and shareholders lost.

II. THUMBNAIL SKETCH OF CODE SECTION 409A

A. The American Jobs Creation Act of 2004 created new Code §409A, which made sweeping changes to the rules applicable to NQDC.

1. NQDC can exist under 409A whether or not the NQDCP is a pension plan under ERISA §3(2) where there is an additional requirement that the compensation be deferred beyond termination of employment.

2. Generally, Code Section 409A governs compensation deferred after 2004.

3. All NQDCPs must operate in compliance with Code Section 409A after 2004.

a. However, documentary compliance is not required until December 31, 2008, in accordance with the latest guidance in Notice 2007-86.

B. If the documentary compliance rules of Code Section 409A are not met by December 31, 2008 or if the NQDCP is not operated in compliance with Code Section 409A after 2004, draconian tax penalties apply to the service provider, not to the employer.

1. Section 409A is not limited to highly compensated employees. It applies to all service providers.

2. The service provider is taxed on the amount deferred if it is or when it becomes vested, whether or not the service provider can collect the money at that time.

a. Notice 2007-89 provides that in the case of account balance plans, the amount deferred is the account balance.

b. The amount deferred in the case of nonaccount balance plans is the present value of all future payments, provided that the amount deferred is reasonably ascertainable.

i. The amount deferred is reasonably ascertainable on the first date on which the amount, form and commencement date are known.

3. The service provider owes a penalty tax equal to 20% of the amount included in income.

4. The service provider owes an additional penalty tax equal to the amount of interest at the underpayment rate plus 1% which would have been charged on the additional tax the service provided would have had to pay had the amount deferred been taxed to the service provider in the year deferred or, if later, in the year in which such deferred compensation became vested.

a. The amount deferred includes a benefit in the future for current services even if the service provider did not have an election to either take the income currently or to defer it.

C. Section 409A applies to a broad spectrum of NQDCPs that may be treated as providing for the deferral of compensation, including:

1. Verbal bonus plans as part of a verbal employment agreement.

2. Individual written employment contracts with bonus or deferral features.

3. Arrangements which permit or require the deferral of salary or bonus.

4. Severance arrangements.

5. Change of control arrangements.

6. Supplemental Executive Retirement Plans (SERPs).

7. Work-force reduction arrangements.

8. Split-dollar life insurance arrangements.

9. Equity compensation arrangements with deferral features, including phantom equity, restricted stock units and stock appreciation rights or options granted at less than fair market value.

10. Top hat and excess benefit plans, either defined contribution or defined benefit.

11. Retirement payments to partners who cease to perform any services to the partnership.

D. Important aggregation rules apply in determining which arrangements constitute a single NQDCP with respect to an individual service provider.

E. To avoid the acceleration of income and penalty provisions of Section 409A, a NQDCP must satisfy in form and in operation certain requirements involving:

1. Elections

2. Permissible Payments.

3. Accelerations.

F. Elections.

1. If a NQDCP permits a service provider to make an initial election to defer a selected amount of compensation, which can be an election as to the time of the payment, an election as to the form of the payment or both, the election must be made and become irrevocable by the end of the service provider's taxable year next proceeding the service year.

a. A special rule applies for the first year of eligibility.

b. In the case of performance based compensation where the performance period is at least 1 year, the election can be made up to 6 months before the performance period ends.

2. If the service provider has no election, the NQDCP must designate the time and form of payment by no later than the later of the time the service provider has a legally binding right to the compensation or the date the service provider would have been required to make the election.

3. The NQDCP cannot permit the service provider to make a subsequent change in the time and form of payment unless:

a. The election cannot take effect until at least 12 months after the date on which it is made.

b. If the election is not related to a payment on account of disability, death or unforeseeable emergency, the payments must be deferred for at least 5 years from the date the payment would otherwise have commenced.

c. In the case of a payment related to a specified time or pursuant to a fixed schedule, the election must be made not less than 12 months before the payment is scheduled to be paid.

d. Changes by the service recipient are also under the same constraints.

e. Nevertheless, life annuity elections (including term certain, social security leveling, pop-up and cash refund feature actuarially equivalent elections) can be made at any time before the annuity payments commence.

f. Elections by an alternate payee under a domestic relations order are permitted.

4. Under a transition rule in Notice 2007-86, service providers and service recipients can make changes in the form and timing of payments through 2008 without violating 409A. In fact, plans can be amended to add the ability to make changes in the time and amount of payment. The limitation is that neither the service recipient nor the service provider can elect to accelerate a payment into the current year nor to delay a payment due in the current year to a later year.

G. Permissible Payments. The NQDCP must provide that deferred compensation may be paid only upon one for the following events or times:

1. The service provider's separation from service, as defined in the regulations.

a. Significantly, the payment must be delayed for 6 months (or until the service provider's death within the 6 month period) on the separation from service of a service provider who is a specified employee of a public company.

b. Remember Enron.

c. Payments may be accelerated within the 6 month period for domestic relations orders, conflicts of interest or payment of employment taxes as permitted under the acceleration rules.

2. The service provider's becoming disabled, as defined in the regulations.

3. The service provider's death.

4. A time or a fixed schedule specified in the NQDCP.

5. A change in the ownership or effective control of the service recipient or in the ownership of a substantial portion of the assets of the service recipient defined in the regulations as change in control events.

6. The occurrence of an unforeseen emergency, as defined in the regulations.

H. Prohibition on Acceleration of Payments.

1. Generally, a NQDCP may not permit in form or operation the acceleration of the time or schedule of any payment or amount scheduled to be paid.

   a. Acceleration of vesting is permitted as long as this does not accelerate the time or schedule of payment.

2. Exceptions. The NQDCP may accelerate the payment or may provide the service recipient the discretion to accelerate payment under the following circumstances (plus a few not mentioned):

   a. To satisfy the requirement of a domestic relations order that the alternate payee be paid earlier.

   b. Compliance with certain ethics or conflict of interest rules.

   c. To pay taxes after a vesting event under 457(f) plans.

   d. Limited cashouts specified in the NQDCP that cash the service provider out of all aggregated NQDCPs.

e. Payment of employment taxes on deferred compensation.

f. Payment upon income inclusion under Section 409A.

g. Cancellation of deferrals following an unforeseeable emergency or hardship distribution under a 401(k) plan.

h. Plan termination and liquidations, under the following circumstances:

i. In connection with a Code section 331 liquidation of a corporation or with approval of a bankruptcy court under 11 U.S.C. §503(b)(1)(A), provided specified requirements are satisfied.

ii. The service recipient's termination and liquidation of all NQDCPs aggregated with each other within 30 days before or 12 month following a change in control event, provided specified requirements are satisfied.

iii. The service recipient terminates and liquidates all aggregated NQDCPs at a time not proximate to a financial downturn and provided specified requirements are satisfied, including the requirement that the service provider cannot adopt an new NQDCP that would be aggregated for 3 years.

I. If an arrangement is a NQDCP governed by Section 409A, its material terms must be set forth in writing, and it may be advisable to included other provisions such as the prohibition on amending a NQDCP and accelerating the benefits except under certain circumstances. A NQDCP's material terms include:

1. The amount or the method or formula for determining the amount of deferred compensation to be provided under the NQDCP.

2. The time and form of payment.

3. The initial deferral election provisions, if any.

4. The subsequent election deferral provisions, if any.

5. The 6 month delay for specified employees of public companies.

6. Cashout acceleration provisions.

7. Other permitted acceleration provisions need not be included but must be added by amendment prior to the time they become effective, according to the final regulations.

J. Certain types of arrangements which defer compensation are specifically excluded from coverage by Section 409A either by the Code or regulation. Some of the more common plans excluded from Section 409A include:

1. Qualified Plans, tax deferred annuities, SEPs and SIMPLE plans.

2. Certain welfare benefit plans, including vacation leave, sick leave, compensatory time, disability pay, or death benefit plans.

3. Payments after the last day of the calendar year in accordance with normal payroll practices.

4. Short term deferrals.

5. Certain separation pay plans, including certain reimbursements and medical benefits.

III. SELECTED PROVISIONS OF THE FINAL REGULATIONS UNDER CODE SECTION 409A

A. The final regulations under Section 409A and Notice 2007-34, which explains 409A's application to split-dollar life insurance arrangements, were issued April 10, 2007.

1. The final regulations are 397 pages long.

2. The final regulations contain some very helpful provisions which were left unclear by earlier guidance.

3. The final regulations were effective on January 1, 2008. Notice 2007-86 generally extended the effective date to January 1, 2009.

a. There are transition rules applicable in 2005-2008. Some of the rules apply to fewer than all of the years.

4. Section 409A governs compensation deferred after 2004 and otherwise grandfathered NQDCPs which are materially modified after October 3, 2004.

5. The final regulations as amplified by Notice 2007-86 make it clear that it is not necessary to amend NQDCPs so as to bring them into documentary compliance with the final regulations prior to December 31, 2008. However, during all of 2005 though 2008 they must have been operated in compliance with the guidance then available including the transition rules. The notice specifies the guidance that may be relied upon during each of the years 2004-2008.

6. All NQDCPs must be in documentary compliance with the final regulations by December 31, 2008.

7. NQDCPs can also operate in compliance with and can satisfy the documentary compliance rules of the final regulations during 2008.

B. Many service recipients will want to design NQDCPs so that they are not governed by Section 409A at all.

1. For specified employees of public companies, this is especially important because payments not governed by Section 409A are not subject to the 6 month delay rule for payments to them upon termination of employment.

C. The most useful exclusion from 409A is the short term deferral exclusion.

1. The regulations provide that there is not a deferral of compensation if the NQDCP does not provide for a "deferred payment" and the service provider actually or constructively receives such payment on or before the 15th day of the third month following the end of the service provider's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture.

a. There is also a 2 ½ month rule after the close of the service recipient's tax year.

b. If the right to payment is always vested, it is considered not to be subject to a substantial risk of forfeiture on the first day the service provider has a legally binding right to the payment.

2. A NQDCP provides for a "deferred payment" if it provides that any payment will be made or completed on or after any date, or upon or after the occurrence of any event, that will or may occur later than the end of the applicable 2 ½ month period, such as a separation from service, death, disability, a change in control event, a specified time or schedule of payment or an unforeseeable emergency, regardless of whether an amount is actually paid as a result of the occurrence of such a payment date or event during the applicable 2 ½ month period.

a. So if the NQDCP provides that the payment must be made within 2 ½ months after the close of the plan year in which the employee quits or is fired, this will not satisfy the short term deferral rule if the employee is vested because the payment may well not occur within 2 ½ months after the close of the plan year in which the employee was vested.

3. There are a few excuses in the regulations which will permit a payment after the 2 ½ month period to still qualify as a short term deferral.

4. However, unless one of the excuses applies, payment after the 2 ½ month period will cause the payment to be classified as deferred compensation governed by Section 409A.

a. Suppose Executive's verbal employment contract provides for a base salary and a bonus of 2 ½% of 2008 taxable income before the payment of the bonus as long as she was employed on December 31, 2008. She satisfies that condition and therefore is vested on December 31, 2008. The in-house accountant computes and pays the bonus to Executive of $100K on March 1, 2009.

i. Since the payment was made within the 2 ½ month period, the bonus is not governed by Section 409A because it is a short term deferral.

b. Suppose alternatively that the accountant figured the employer was on a safe estimate basis and extended the due date of the employer's tax return. He got around to computing and paying the bonus to Executive on May 12, 2009.

i. The short term deferral exception is not satisfied. The NQDCP is governed by Section 409A. Among other things, the verbal NQDCP fails to satisfy the written plan requirement of Section 409A. Executive is probably taxed on the $100K in <u>2008</u>. In addition to the 41% or $41K combined federal and state tax Executive owes on the $100K, she will owe an additional $20K federal tax for 2008. Executive has only $39K left over after tax.

ii. If the verbal agreement was that Executive was not entitled to the bonus otherwise due unless she was employed on the payment date, the payment on May 12, 2009 would be satisfy the short term deferral rule and thus would not be counted as deferred compensation.

iii. Executive's right to the compensation ceased to be subject to a substantial risk of forfeiture on the same day the payment was made. To satisfy the short term deferral rule, Executive must be paid within 2 ½ months after the close of the year in which Executive ceased to be subject to a substantial risk of forfeiture and that period does not expire until March 15, 2010.

iv. Here the issue is one of proof of the deal. They must be in a position to prove to the IRS that the verbal agreement was that the Executive did not vest until the payment date.

5. The final regulations provide a safe harbor even if the 2 ½ month deadline is missed in the provisions governing the specified time or fixed schedule payment triggers for NQDCPs which are not excluded from Section 409A by the short term deferral provisions. If the NQDCP is in writing, as is required, and also states that the payment must be made in a single calendar year and within 2 ½ after the beginning of the year, the regulations provide that a payment at any time during the entire calendar year satisfies Section 409A.

a. If the payment is made as required within the 2 ½ months, it satisfies the short term deferral rule and is not governed by Section 409A.

b. If that deadline is missed, the NQDCP is governed by 409A. However, the terms of the NQDCP and its operation satisfy the specified time or fixed schedule rule and thus complies with 409A.

i. Note that the 6 month delay for specified employees of public companies does not apply to payments pursuant to the specified time or fixed schedule trigger.

c. It's a good idea to state that the payment of the bonus shall be made on or after January 1 and on or before March 15 of the year following the service year so that it either is excluded from Section 409A by the short term deferral rule or, if the March 15 deadline is missed, it is governed by 409A but it satisfies the specified time or fixed schedule rule.

D. As mentioned earlier, certain welfare benefit plans are entirely excluded from Section 409A.

1. The final regulations make it clear that a death benefit plan is excluded only if there are no lifetime benefits payable. Thus, if the service provider is entitled to $100 per month but if he dies his spouse is entitled to the $100 per month, that is not an excluded death benefit plan. If the plan provided no benefit to the service provider but provided a death benefit only to his spouse of $100 per month on his death, that would be an exempt death benefit plan.

a. Endorsement or economic benefit regime split-dollar life insurance arrangements which have no equity are also excluded death benefit plans under this rule. The imputed income factor is not treated as a lifetime benefit to the service provider.

b. Collateral Assignment split-dollar arrangements and those governed by the loan regime are excluded from Section 409A.

2. Archer Medical Savings Accounts, HSAs or any other medical reimbursement arrangement, including a health reimbursement arrangement that satisfies the requirements of Sections 105 or 106 of the Code such that the benefits or reimbursements are not includible in income are not governed by Section 409A.

E. Certain collectively bargained separation pay plans, separation pay due to involuntary separation (including a good reason voluntary separation) from service or participation in a window program are excluded from Section 409A if certain conditions are met.

1. Separation pay plans condition the right to payment of the compensation upon a separation from service.

F. There is an important but relatively narrow exclusion from Section 409A for reimbursements and certain other payments under voluntary or involuntary separation pay plans (including individual employment contracts).

1. The payments must be made before the close of the second year following separation from service (even though the right to payments may extend beyond such period under a part of the plan governed by Section 409A).

2. The reimbursements (including direct payments to a third party for the service provider) or in-kind benefits which qualify include only:

a. Amounts which the service provider could deduct under Sections 162 or 167 as business expenses incurred in connection with the performance of services (ignoring phase outs based on adjusted gross income).

b. Reasonable outplacement and moving expenses including loss on the sale of the service provider's primary residence.

G. There is also a medical benefits exclusion from Section 409A under separation pay plans including voluntary ones.

1. The service provider can be reimbursed for medical expenses which are not reimbursed by a third party such as an insurer provided that the service provider could deduct the payments as medical expenses ignoring the 7.5% of adjusted gross income floor on the deductions.

2. The reimbursements cannot extend beyond the COBRA coverage period the service provider would have been entitled to had the service provider elected COBRA coverage.

H. If not otherwise excluded, a taxpayer may treat a right under a separation pay plan payments as not providing for a deferral of compensation to the extent such payments in the aggregate do not exceed the applicable dollar limit on elective deferrals under Section 402(g)(1)(B) of the Code.

1. $15,500 for 2007.

I. In NQDCPs governed by Section 409A, one permissible trigger event for payment is separation from service.

1. Historically, many employers and employees would decide that the employee needed to collect his qualified and NQDCP benefits.

2. They would decide that the employee had retired or otherwise terminated employment as an employee and hire the former employee back as an independent contractor. Since the employee's employment was terminated, he could take his benefits under both qualified and NQDCPs.

3. If that ever worked, it won't work under Section 409A.

4. The trigger event under Section 409A is separation from service, which includes death, retirement or other termination of employment with the employer.

5. Whether a termination of employment has occurred is a facts and circumstances determination.

   a. A termination of employment occurs if the employer and employee reasonably anticipate that no further services will be performed after a certain date or that the level of bona fide services the employee would perform after such date (whether as an employee or as an independent contractor) will permanently decrease to no more than 20% of the average level of bona fide services performed over the immediately preceding 36 month period.

   b. Facts and circumstance to be considered in making such determination include:

      i. Whether the employee continues to be treated as en employee for other purposes, i.e. salary continuation, participation in other employee benefit programs.

      ii. Whether others have been treated consistently.

      iii. Whether the employee is permitted and realistically available to perform services for others in the same business.

   c. There is a safe harbor. The employee is presumed to have separated from service where the level of bona fide services performed decreases to a level equal to 20% or less of the average level during the prior 36 months.

   d. Likewise, if the level is 50% or more, there is a presumption of no separation from service.

   e. No presumption in between.

6. There are special rules which govern separation from service of an independent contractor.

J. Disability can be a payment trigger even if the service provider remains employed (although it is hard to see how continued employment is possible given the definition of disability).

1. This is called a single trigger.

2. The definition of disability is difficult under Section 409A.

3. Disability means that, by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, the service provider is unable to engage in any substantial gainful activity or is receiving income replacement benefits for a period of not less than 3 months under an accident and health plan covering employees of the service recipient. The service provider will be deemed disabled if determined to be disabled in accordance with the service recipient's disability program, provided that the definition of disability under such disability insurance program complies with the definition in the preceding sentence. Also, the service provider will be deemed disabled if determined to be totally disabled by the Social Security Administration.

4. If this definition is not acceptable, apparently, the service recipient can just use any definition of disability it wants provided that disability under the definition used is merely a vesting event and not a payment trigger.

   a. The NQDCP provides that the service provider becomes 100% vested upon the chosen definition of disability.

   b. If the service provider then separates from service, a permissible trigger event, the service provider will be entitled to the payment.

   c. Called a double trigger.

   d. Of course, if the serviced provider is always 100% vested and you want a payment upon separation from service on account of disability, just don't mention disability.

K. The earlier guidance on the specified time or fixed schedule payment trigger caused concerns about how to design NQDCPs which contemplated payments that were not fixed in amount or time, such as reimbursements, in-kind or tax gross-up payments.

1. These are deferrals that are governed by Section 409A because the payments or in-kind benefits are outside of the reimbursement payment period for separation pay reimbursements or they do not satisfy the requirements for separation pay reimbursements and in-kind benefits.

2. The final regulations are very helpful and provide much needed flexibility.

3. A NQDCP satisfies the specified date or fixed schedule trigger for reimbursements or in-kind benefits if it satisfies certain fairly easy to meet requirements.

   a. Such expenses must be clearly defined in an objectively determinable nondiscretionary fashion, but the amounts to be reimbursed do not have to be specified or known in advanced.

   b. The reimbursement period must be specifically stated but can be for the life of the service provider.

   c. The amounts reimbursed in 1 year cannot affect the amount reimbursable in any other year, except there can be an overall cap for medical expense reimbursements.

      i. This provision can cause some practical difficulties.

   d. The reimbursements must be made on or before the last day of the service provider's taxable year following the taxable year in which the expense was incurred.

   e. The right to reimbursement must not be subject to liquidation or exchange for another benefit.

   f. A NQDCP can provide for a tax gross-up provided the plan states that the reimbursement must be paid by the end of the service provider's taxable year next following the service provider's taxable year in which the service provider remits the related taxes.

g. A tax gross-up payment refers to a reimbursement for the taxes the service provider incurs as a result of the taxable reimbursement including a gross-up to cover the taxes on the gross-up itself.

L. A Change in control event can be a payment trigger.

1. If it is, the regulations provide a very detailed but pretty good definition of change in control events.

2. For this definition to be required, the change in control event itself must be the payment trigger, i.e. a single trigger, even if the service provider remains employed.

3. Like disability, if you want the service provider to have to terminate employment before he is entitled to payment following a change of control, any definition of change of control can be used as a vesting event if the service provider is not already vested.

   a. The payment trigger is separation from service.

   b. Again, a double trigger.

IV. 2007 REPORTING AND WAGE WITHHOLDING REQUIREMENTS

A. Notice 2007-89 delayed through the 2007 year any obligation to report amounts deferred in 2007 that are not included in income in 2007 under 409A on forms W-2 or 1099-MISC.

B. However, if any deferred compensation is included in income because of an operational violation of 409A in 2007, the amount must be reported on form W-2 and 1099-MISC and proper withholding is required for employees.

1. The Notice explains the withholding rules.