Caution—your deferred compensation may be subject to a 20% haircut courtesy of 409A.

A PLEASANT ALTERNATIVE TO ROOT CANAL?

JONATHAN CHAPMAN, CPA

Congress enacted Internal Revenue Code section 409A in 2004 to address perceived abusive arrangements involving nonqualified deferred compensation plans ("NQDC"). Employees and independent contractors (collectively referred to as "Service Providers") are exposed to severe tax consequences if the plan fails to comply with 409A.

Specifically, an NQDC plan's failure to comply with 409A will result in an acceleration of deferred compensation into taxable income upon vesting, a 20% penalty on the deferred compensation and a possible interest charge on any tax deferred from the year of vesting to the year in which reported in taxable income. For example, deferred compensation vested in 2008 of $50,000 and paid and included in taxable income in 2010 would be subject to a $10,000 penalty and an interest charge on the tax deferred if the NQDC plan fails to comply with 409A. Given the complexity and scope of 409A, a failure to comply is a very real possibility unless employers carefully review all plans that may be covered under these provisions. A simple bonus declared in 2008 and paid after March 15, 2009, could trigger the 409A penalties.

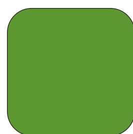
Basic requirements

There are three basic requirements under 409A. First, distributions under the NQDC plan may be made only upon specific events. Second, distributions may not be accelerated from the time or schedule of any payments under the plan with certain exceptions including required payments to an individual other than the service provider under a domestic relations order and plan terminations and liquidations. Third, subject to exceptions, the election to defer compensation must be made by the close of the taxable year preceding the year in which the services are performed. Exceptions to this general timing of the election to defer compensation are provided for in the case of

JONATHAN CHAPMAN is a tax partner in the Boston, Massachusetts office of Feeley & Driscoll, P.C. He is a CPA with over 30 years experience in providing tax consulting services and specializes in the construction industry. Mr. Chapman is a member of the AICPA and Massachusetts Society of CPAs.

the first year in which the service provider is eligible to participate in the plan and in the case of certain performance-based compensation plans.

Section 409A requires both operational and contractual compliance. In other words, in addition to operating the plan in compliance with the rules under 409A, these rules must be reflected in written documents. Although 409A is generally effective in 2005, the written documentation requirement was deferred to December 31, 2007, through interim guidance provided by the IRS and Treasury (collectively, "Treasury") such that taxpayers could avoid violating 409A by operating in good faith with such interim guidance.[1]



SECTION 409A REQUIRES BOTH OPERATIONAL AND CONTRACTUAL COMPLIANCE.

Treasury issued final regulations under 409A on April 10, 2007. These regulations retain the December 31, 2007, effective date for written documentation. However, as a bit of good news, Treasury issued Notice 2007-78 that, in general, delayed the written documentation requirement to December 31, 2008. This means that taxpayers must identify all of their plans that meet the definition of an NQDC plan and either amend existing plans or draft new plans that comply with these regulations by December 31, 2008. Considering the scope and complexity of 409A and the regulations, this will be a lengthy process in many cases.

It should be noted that, although Notice 2007-78 does provide some relief, it does require that the plan designate in writing before January 1, 2008, a compliant time and form of payment of the nonqualified deferred compensation. For example, the plan may provide that an amount deferred under the plan will be paid in the form of a life annuity commencing on the later of the service provider's separation from service or attaining age 65. However, a plan may not provide that an amount deferred under the plan will be paid during the three years following the service provider's separation from service. Careful attention to this written compliant time and form of payment provision under the Notice is important by December 31, 2007.

The regulations are set up in four parts consisting of provisions defining NQDC plans and the various exceptions and exclusions to such plans, provisions describing the form and timing of deferral elections, special rules related to permissible payments under NQDC plans and certain transitional rules.

NQDCs; the basics

The regulations begin by defining a nonqualified deferred compensation plan as any plan that provides for the deferral of compensation.[2] This is a very broad definition[3] in that the reference to "any plan" could encompass plans not thought of as a deferred compensation plan in the traditional sense. For example, certain taxable medical reimbursement plans would fit this definition. The point here is that it is imperative to review all employee benefit plans for possible exposure to 409A.

Compensation is deferred if, under the terms of the plan, the service provider has a legally binding right to compensation during a taxable year (generally the year in which the underlying services are performed) that, under the plan, is *or may be* payable to the service provider in a later taxable year.[4]

Note the subtlety with reference to "may be payable" in a later year. According to the preamble to the regulations, compensation that is deferred to a future year but is paid in the earlier year in which the compensation is earned will constitute deferred compensation, even though the payment was not in fact deferred. To make matters worse, such payment may constitute a violation of the prohibited acceleration payment rules and therefore will be subject to the 409A penalties.

For example, employee Bob elects in 2008 to defer $30,000 salary earned in 2009 to 2011. Bob's employer instead pays this amount to Bob in 2009. Although Bob has not in fact deferred the compensation as it is paid in the same year in which he earns it, such compensation will constitute deferred compensation because it "may be payable" in 2011. The consequence of this is that the plan is in violation of the acceleration provisions under 409A and, therefore, Bob is sub-

EXTEND TRANSITIONAL RELIEF IN APPLICATION OF 409A TO NON QUALIFIED DEFERRED COMPENSATION PLANS

As this article was going to press, the IRS issued a notice providing additional transitional relief in the application of 409A to certain plans.

The IRS recently issued Notice 2007-86. This notice provides additional transition relief regarding the application of 409A to NQDC plans by extending to December 31, 2008, the transition relief that was scheduled to expire on December 31, 2007, as provided in Notice 2006-79 and the preamble to the final regulations. Such transition relief includes changes to the form of payment elections and the time of the payment of NQDC such that changes may be made until December 31, 2008, without the changes being treated as an acceleration of a payment or being subject to 409A's restrictions on subsequent deferrals. This provision retains the restriction where elections to change the time and form of payment cannot delay receipt to a later year of amounts otherwise payable in 2008 or accelerate to 2008 amounts otherwise not payable in 2008.

For example, amounts otherwise payable in 2009 may be deferred to 2010 but not accelerated to 2008 where the election is made in 2008. This is an extremely important transition rule that should be considered carefully. The Notice also extends to December 31, 2008, the ability to replace discounted stock rights (as discussed earlier, generally problematic) with new undiscounted stock rights that comply with 409A. Importantly, compliance with the final regulations is not required before January 1, 2009, a one-year delay. Instead, NQDC plans may be operated through December 31, 2008, in compliance with the provisions of 409A and applicable provisions in other transition guidance, including Notice 2005-1 and any other generally applicable guidance published with an effective date prior to January 1, 2008. The plan must be amended on or before December 31, 2008, to conform to the provisions of 409A and the final regulations.

ject to a $6,000 penalty.[5] Will Bob ever be surprised!!

What's excluded?

The regulations specifically exempt from 409A qualified employer plans such as pension and profit sharing plans, SEPs, Simple plans and 457(b) plans. Also excluded are certain welfare benefit plans including vacation leave, sick leave, compensatory time, disability pay and death benefit plans, as well as health reimbursement arrangements providing benefits or reimbursements that are not includible in taxable income and Archer Medical Savings Accounts and health Savings Accounts.[6]

Short-term deferrals; basic rule

As defined, a plan must provide for the deferral of compensation in order to be subject to 409A. The regulations provide a very important exception in the case of "short-term deferrals" in that short-term deferrals do not result in the deferral of compensation.[7] Accordingly, short-term deferrals are not subject to 409A.

A short-term deferral occurs where the compensation is paid on or before the 15th day of the third month (referred to as the applicable 2 1/2 month period) following the later of the service recipient's (i.e., the employer) or service provider's year in which the right to the payment is no longer subject to a substantial risk of forfeiture. If such compensation is never subject to a substantial risk of forfeiture, it is considered to be no longer subject to a substantial risk of forfeiture on the first date the service provider has a legally binding right to the payment.[8]

For example, ABC Construction Company awards a bonus to employee Jane on December 1, 2008. The bonus is not subject to a substantial risk of forfeiture. ABC is a calendar year taxpayer. If ABC pays Jane on or before March 15, 2009, the bonus plan will not be considered to provide for the deferral of compensation and 409A will not apply as the bonus was paid on or before 2 1/2 months following the end of the year in which the bonus is (deemed) no longer subject to a substantial risk of forfeiture.

If, instead, ABC is a November fiscal year end and the bonus is awarded to Jane on December 1, 2008, the payment dead-

line to constitute a short-term deferral is February 15, 2010, the 15th day of the third month following the later of the service recipient's year (November 30, 2009) or the service provider's year (December 31, 2008) in which the payment is no longer subject to a substantial risk of forfeiture. In this case, Jane can defer tax on this compensation for an additional year (2010 vs. 2009) because of her employer's fiscal year.

Assume that calendar year ABC awards a bonus to Jane on December 1, 2008, where Jane will forfeit the bonus unless she continues to perform services through December 31, 2010. In that case, the bonus is subject to a substantial risk of forfeiture through 2010, at which time the bonus is no longer subject to a substantial risk of forfeiture. The applicable 2 1/2 month period is with reference to December 31, 2010, such that the bonus must be paid to Jane by March 15, 2011.[9]

A subtle exception

There is a subtle exception to the short-term deferral rule: The rule provides that, if the plan provides for any payment that will or may be made later than the end of the applicable 2 1/2 month period, such as a separation from service, the plan provides for a deferred payment and the short-term deferral rule does not apply.[10] This would be the case even if the particular event, such as a separation from service, occurred within the 2 1/2 month period because the event and, therefore, the payment, could have been made on a date subsequent to the 2 1/2 month date.

It may be advisable to document the bonus and payment date in writing even though it is anticipated that the bonus will be paid within the 2 1/2 month period and, therefore, excluded from 409A. In the event the employer is unable to pay the bonus by the short-term deferral deadline, a special rule exists that will treat the payment as having been made on the scheduled date as long as it is paid within the same taxable year of the service provider.[11]

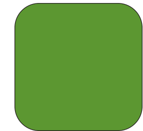
Substantial risk of forfeiture

The determination of whether there is a substantial risk that the deferred compensation may be forfeited and, if it does, the period of the risk is very important under 409A. For example, as discussed earlier, the short-term deferral rules are based on the year in which the right to payment is no longer subject to a substantial risk of forfeiture. If a legally binding right to compensation occurs in 2009 and payment is made by March 15, 2011, under the assumption that a substantial risk of forfeiture runs from 2009 through 2010, it would be important that the condition qualifies as a substantial risk of forfeiture. If it did not (e.g., the condition is a covenant not to compete that does not qualify as a substantial risk of forfeiture under 409A), the payment would not qualify for the short-term deferral and, as a result, could be in violation of 409A.

Section 409A(d)(4) provides that substantial risk of forfeiture exists where an individual's rights to compensation are conditioned upon the future performance of substantial services by the individual. The regulations expand on this definition by providing that compensation is subject to a substantial risk of forfeiture if the amount is conditioned on the performance of substantial future services or the occurrence of a condition related to a purpose of the compensation such as attaining a certain level of earnings or completing an initial public offering, and the possibility of forfeiture is substantial.

Separation from service without cause. An involuntary separation from service without cause (e.g., a layoff) is included in the definition of substantial risk of forfeiture.[12] For example, a separation pay plan that is payable in the event the separation is involuntary and without cause from the employee would come under this if the possibility of a forfeiture is substantial. In other words, in the event such an involuntary separation does not occur, then the deferred compensation is forfeited.

Good reason voluntary separation from service. As discussed above, an involuntary separation from service without cause is specifically included as a risk of forfeiture if the possibility of forfeiture (i.e., separation from service does not occur) is substantial. What about a situation where an employee voluntarily



THE SHORT-TERM DEFERRAL RULES ARE BASED ON THE YEAR IN WHICH THE RIGHT TO PAYMENT IS NO LONGER SUBJECT TO A SUBSTANTIAL RISK OF FORFEITURE.

leaves because of certain negative changes in his employment relationship?

As one of the favorable modifications to the proposed regulations, the final regulations include a voluntary separation from service with good reason as an involuntary separation from service. Good reason is generally based on facts and circumstances where the service recipient has taken actions that result in a material negative change to the service provider's service relationship.[13] For example, changing coffee service would not likely constitute a material negative change but a material reduction in the service provider's compensation would. Other indications of a material negative change would include the service provider's duties to be performed, or the conditions under which such duties are to be performed.

THE REGULATIONS AND THEIR PREAMBLE PROVIDE CONSIDERABLE ATTENTION TO STOCK RIGHTS.

The regulations provide a very structured, time-sensitive safe harbor system under which a voluntary separation from service with good reason is deemed to exist and, therefore, included as an involuntary separation from service. Specifically, the safe harbor refers to five specific conditions as well as any other action or inaction that constitutes a material breach by the service recipient of the agreement under which the service provider provides services any one of which constitutes a material negative change. These conditions include a material diminution of pay, duties, authority, or responsibilities as well as a material change in the geographic location at which the service provider must perform services.[14]

The safe harbor also requires that certain time-sensitive actions must occur on the part of the service provider. First, the service provider must separate from service within two years following the initial existence of one or more of these 6 conditions. Second, the service provider must provide notice to the service recipient within 90 days of the initial existence of the condition. Finally, the service recipient must have at least 30 days to remedy the condition.[15]

As these safe-harbor conditions are very structured and time sensitive, there will be some practical problems in adhering to these safe-harbor rules. Employee documentation is very important to support adherence to these time lines (e.g., the date the condition first came into existence, the date the notice was provided to the service recipient, etc.).

So, what does all of this mean? First, the voluntary separation from service for good reason constitutes a substantial risk of forfeiture. This means the payment may be deferred to a year following the year in which the substantial risk of forfeiture lapses (i.e., the year of separation). At that point, the service provider vests in the separation pay.[16] If the separation pay is payable and paid within the short-term deferral period following the year of separation and the other short-term deferral rules are met (e.g., the plan does not provide for a payment date that "may" occur after the 2 ½ month period), the plan is exempted from 409A, as discussed earlier. If, on the other hand, the voluntary separation from service plan were without good reason, entering into the agreement would constitute a deferral of compensation with immediate vesting and, likely, in violation of 409A.

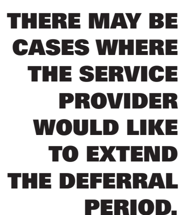
Second, as a voluntary separation from service for good reason, the plan is treated as an involuntary separation from service plan.[17] The regulations exclude from 409A separation pay due to an involuntary separation from service "to the extent" that the separation pay does not exceed two times the lesser of the annualized compensation for the year prior to the year of separation or the qualified plan limitation under 401(a)(17) ($225,000 for 2007) and the plan provides that the separation pay must be paid no later than the last day of the second year of the service provider following the taxable year of the service provider in which occurs the separation from service.[18] The "to the extent" quotation is to highlight the effect that this is not an all-or-none provision. In other words, if the limitation is 2 times the 401(a)(17) amount of $225,000, or $450,000, and the separation pay totals $500,000, 409A only applies to the excess, or $50,000.

Aside from the favorable tax results in the exclusion from 409A, separation pay plans for good reason may be of interest as a protective measure to a prospec-

tive employee in negotiating his or her employment agreement.

Stock rights

The regulations and their preamble provide considerable attention to stock rights. Stock rights are comprised of nonqualified stock options and stock appreciation rights. Stock options with an exercise price at or above the fair market value of the underlying stock on date of grant generally do not constitute deferred compensation and 409A does not apply.[19] A stock option that is issued with an exercise price lower than the fair market value of the underlying stock on the date the option is granted generally has a problem in complying with 409A where the option may be exercised beyond the tax year of the recipient in which it is issued. Similar rules apply to stock appreciation rights.



THERE MAY BE CASES WHERE THE SERVICE PROVIDER WOULD LIKE TO EXTEND THE DEFERRAL PERIOD.

This makes the determination of the stock's fair market value critical. This determination is relatively simple in the case of publicly traded stock but more difficult and uncertain in the case of non-publicly traded stock. The regulations provide considerable guidance and safe harbors, such as third-party appraisals, in valuing non-publicly traded stock. The risk upon examination is that the IRS values the stock on date of grant at an amount greater than the exercise price. This, in turn, can easily trigger penalties under 409A.

Deferral elections

In the case of a service provider, an election to defer compensation must be made by the end of the service provider's taxable year preceding the year in which the underlying services are performed. For example, a service provider must elect by December 31, 2007, to defer compensation to be earned in 2008. There is an exception where the service provider is required to perform services for at least 12 months subsequent to the date he obtains a legally binding right to the compensation. In that case, the election may be made on or before the thirtieth day following the date he obtains the legally binding right as long as the election is made at least 12 months before the earliest date the forfeiture condition could lapse.

Initial deferral elections. In the case of the first year in which the service provider is eligible to participate in the deferred compensation plan, the election may be made within 30 days after the service provider becomes eligible to participate in the plan. In addition, in the case of performance-based deferred compensation plans, the election to defer compensation under such plans may be made within six months before the end of the performance period.[20] The performance period must be for a period of at least 12 months.[21] In both cases, the deferred compensation does not include compensation earned prior to the election date.

Subsequent deferral elections. There may be cases where the service provider would like to extend the deferral period. The regulations allow for this under certain rules. In general, the scheduled payment must be at least 12 months subsequent to the date of the deferral election and the subsequent deferral period must be at least 5 years except in the case of death, disability, or the occurrence of an unforeseeable emergency.[22]

Permissible payments

Section 409A limits payments under nonqualified deferred compensation plans to the following events:

1. Separation from service
2. Disability
3. Death
4. A specified time or fixed schedule
5. Change in corporate ownership or control or ownership of a substantial portion of the corporate assets
6. Occurrence of an unforeseeable emergency[23]

Separation from service. In defining "separation from service," the regulations provide that a termination of employment constitutes a separation from service. A termination of employment does not include military leaves, sick leaves or other bona fide leaves not exceeding 6 months. In addition, leaves exceeding 6 months do not constitute employment termination if the individ-

ual retains statutory or contractual rights to reemployment. In general, a termination of employment is based on facts and circumstances with safe harbors such as a reduction in services to no more than 20 percent of the average level of services performed over the prior 36 months.[24] Again, the regulations provide extensive guidance as to what constitutes a termination of employment and, therefore, a separation from service, because of Treasury's concern that this is an event that can be easily manipulated.

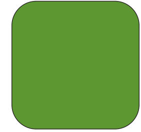
Specified time or fixed schedule. A specified time or fixed schedule exists where, at the time the amount is deferred, the time or fixed schedule is objectively determinable. For example, a payment date in the year following the year the service provider's child graduates from college is not objectively determinable. However, a payment date upon the employee attaining the age of 55 would be objectively determinable. Again, the regulations give considerable attention to when a specified time or fixed schedule is objectively determinable.

Flexibility is provided in allowing for an alternative payment date in the case of the service provider's death, disability, a change in corporate ownership or the occurrence of an unforeseeable emergency. In addition, a plan may allow for an alternative payment schedule if the event occurs on or before one specified date. An example is provided where a plan may provide that a service provider will receive a lump sum payment of his entire benefit on the first day of the month following a change in control event that occurs before he attains age 55, but will receive 5 substantially equal annual payments commencing on the first day of the month following a change in control event that occurs on or after he attains the age of 55.[25]

Other events

The regulations provide extensive guidance and definitions regarding disability, change in ownership and the occurrence of an unforeseeable emergency. Disability is defined in part as the inability of the service provider to engage in any substantial gainful activity by reason of a physical or mental impairment that can be expected to result in death or last for at least 12 months. The determination of disability can be with reference to, and in in accordance with, a disability insurance program.

A change in corporate ownership consists of a change in the ownership of the corporation, a change in effective control of the corporation or a change in the ownership of a substantial portion of the assets of the corporation. In general, a change in the ownership of the corporation occurs from an acquisition of stock constituting more than 50 percent of the total fair market value or total voting power of the stock of the corporation. A



THE DOWNSIDE RISK OF NOT COMPLYING CAN BEST BE DESCRIBED AS A PARADE OF "HORRIBLES" INFLICTED ON THE EMPLOYEE.

change in the effective control of the corporation occurs from an acquisition by any one person, or more than one person acting as a group, of stock of the corporation possessing 30 percent or more of the total voting power of the stock of the corporation during the 12-month period ending on the date of the most recent acquisition by such person. Finally, a change in ownership of the corporation occurs from the acquisition of 40 percent of the fair market value of all the assets of the corporation over a 12-month period.

Finally, an unforeseeable emergency is a severe financial hardship to the service provider resulting from an illness or accident of the service provider, the service provider's spouse, the service provider's beneficiary or dependent and as a result of the service provider's property loss, due to casualty, or similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the service provider.

The regulations provide substantial guidance in further defining these events.[26]

Conclusion

The regulations and preamble are extensive, with over 300 pages including numerous examples illustrating many of the complex rules under 409A. The downside risk of not complying can best be described as a parade of "horribles" inflicted on the employee. Careful attention must be given to these rules and, although the contractual requirements are deferred for a year under Notice 2007-78, there is a sense of urgency in attending to certain favorable transition rules that will be expiring at the end of 2007 and certain elections that must be made by the end of this year. The unsuspecting employee may well describe the 409A "experience" as a root canal—without the Novocain! ■

NOTES

1 See, e.g., Notice 2005-1, IRB 2005-2, 274, 2005-1 CB 274 and proposed regulations issued September 2005.

2 Treas. Reg. Sec. 1.409A-1(a) ("Section").

3 See Section 1.409A-1(c)(1) defining "plan" to include any agreement, method, program, or other arrangement that may be adopted unilaterally by the service recipient or negotiated between the service recipient and one or more service providers.

4 Section 1.409A-1(a). The preamble to the regulations defines "legally binding" to include contractual rights that are enforceable under applicable laws governing the contract. Sec. 1.409A-1(b) excludes from this definition compensation that may be reduced unilaterally or eliminated by the service recipient or other person after the services creating the right to the compensation have been performed. Such discretion is based on the particular facts and circumstances. The regulation elaborates on whether such discretion in substance exists (e.g., the service provider may have control over the person retaining such discretion).

5 Preamble TD 9321, III A; see 409A(a)(3) and Section 1.409A-3(j).

6 Sections 1.409A-1(a)(2) and 1.409A-1(a)(5).

7 Sec. 1.409A-1(b)(4).

8 Id.

9 See Section 1.409A-1(b)(4)(iii) for examples of short-term deferral rule.

10 Sec. 1.409A-1(b)(4)(i)(D).

11 Section 1.409A-3(d). This regulation is actually more expansive in that it permits a payment date beyond the service provider's taxable year. Specifically, payment may be made by the fifteenth day of the third calendar month following the date specified in the plan where the service provider is not permitted directly or indirectly, to designate the taxable year of the payment. For example, if the designated payment date were November 1, 2009, payment will be deemed made on such designated dated if made by the later of December 31, 2009 (i.e., within the service provider's taxable year) or February 15, 2010 (i.e., the fifteenth day of the third calendar month following the date specified in the plan), as long as the service provider is not permitted, directly or indirectly, to designate the taxable year of the payment (i.e., 2009 or 2010). In addition, payment will be treated as made on the designated payment date if it is paid no earlier than 30 days before the designated payment date and the service provider is not permitted, directly or indirectly, to designate the taxable year of the payment.

12 Section 1.409A-1(d)(1).

13 Section 1.409A-1(n)(2).

14 Id.

15 Id.

16 Without this, the substantial risk of forfeiture lapses in the year the service provider obtains a legally binding right to the compensation (generally, in the year it is earned).

17 Section 1.409A-1(n)(2).

18 Section 1.409A-1(b)(9)(iii).

19 Section 1.409A-1(b)(5). In addition, the number of shares under the option must be fixed at date of grant, the transfer of the option must be subject to tax under IRC section 83 and the option must not include any feature for the deferral of compensation other than the deferral upon the later of exercise or vesting of the underlying stock.

20 Section 1.409A-2(a)(8).

21 Section 1.409A-1(e).

22 Section 1.409A-2(b).

23 Section 1.409A-3(a).

24 Section 1.409A-1(h).

25 Section 1.409A-3(c).

26 Sections 1.409A-3(i)(3), (4) and (5).