

SECTION 409A—AN OVERVIEW

Steven D. Woodland
Stoel Rives LLP

May 14, 2008

Caveat: This outline is not intended to be a complete discussion of 409A and its implications. It should not be relied upon as legal advice. It is not federal tax advice. The application of the law may vary due to different factual situations.

I. Why The Concern Over Section 409A?

A. 409A Does Not Replace Existing Tax Principles Governing Deferred Compensation

1. Income reported based upon accounting method (IRC 451)
2. Existing doctrines, such as constructive receipt, economic benefit (including property transfer rules of IRC 83), and assignment of income still apply

B. Tax Consequences of Violation of 409A by Deferred Compensation Arrangement With Respect to a Participant

1. Participant (or Service Provider)

- a. Taxed for federal income tax purposes immediately on all deferred compensation under all plans of the same type not subject to a substantial risk of forfeiture (unless already included in income)
- b. 20% additional tax on all amounts required to be included in income as a result of the violation
- c. Interest on underpayment (underpayment rate plus 1%) for each of the prior years in which the amounts would have been included in income if not deferred

2. Employer (or Service Recipient)

- a. Must annually report amounts deferred under a nonqualified deferred compensation arrangement on employee's W-2 or 1099 of independent contractor

- (1) This requirement has been delayed by IRS notice for 2005, 2006 and 2007
 - b. Withholding required on amounts includable in income as a result of violations of 409A
- 3. Employment taxes not generally impacted by 409A
 - a. Individual account plans generally are subject to employment taxes when amount is earned (or cease to be subject to a substantial risk of forfeiture, if later)
 - b. Non-account plans are generally subject to employment taxes when amount deferred can be ascertained
- 4. Deduction by Employer
 - a. Timing of deduction continues to be governed by IRC 83 and 404(a)(5)
 - b. If timing of income is accelerated by 409A, then timing of related deduction is accelerated.
- 5. Except where otherwise provided in guidance, 409A applies as if a separate plan or plans were maintained for each service provider.
 - a. Thus a violation in a plan that relates only to a single participant will require income inclusion and penalties for deferrals in all of the same types of plans only for that participant and not others participating in the same plan or plans.
- 6. If person is both an employee and an independent contractor, the deferred compensation arrangements that arise from employee status are not aggregated with the deferred compensation arrangements that arise from status as an independent contractor

II. Requirements For Arrangements Subject to 409A

- A. Any arrangement that provides for the “deferral of compensation” is subject to 409A unless an exception can be found.
 - 1. Deferral of compensation broadly defined as taxable compensation to which the service provider has a legally binding right and that is (or

may be) payable in a year after the year in which the compensation was earned.

- a. Service provider includes both employees and nonemployees, such as independent contractors and board members.
 - b. Independent contractors who are providing services to two or more unrelated service recipients (other than as an employee or director) are generally not considered service providers under 409A.
2. The deferred compensation may be a commitment to pay money to an employee in a future year. The deferred compensation may also be rights to benefits, reimbursements and in-kind payments for several years after termination of employment, such as entitlement to continuing medical plan coverage or reimbursement for moving expenses.
 3. Keys questions are:
 - a. Is there compensation for services?
 - b. Is it taxable for federal income tax purposes?
 - c. Is there a legally binding right to the compensation?
 - d. Is it possible that it may be payable in a year after the year in which it was earned?
 4. Watch out for less obvious types of deferred compensation in the form of promises (written or oral) to pay something or provide something in a future year or years, including those in offer letters, separation agreements, letters of intent, escrows for earnouts in transactions, employment agreements and partnership agreements
- B.** There are a number of exclusions and exceptions from 409A for certain arrangements. Some of the applicable exclusions and exceptions will be discussed below with respect to various types of common arrangements.
1. The more significant exceptions are the following
 - a. Qualified plans (i.e. 401(a) plans (such as pension, profit-sharing, 401(k) plans, and stock bonus plans such as ESOPs), 403(a) annuity plans, 403(b) annuities, SEPs under 408(k), SIMPLE accounts under 408(p), 457(b) plans)

- b. Bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit arrangements**
- c. Amounts in an Archer medical savings account described in IRC 220, health savings accounts under IRC 223, and any other medical reimbursement arrangement, including a health reimbursement arrangement that satisfies IRC 105 and 106 such that the reimbursements are not includible in income**
- d. Short term deferrals**
 - (1) Terms of plan require payment of amount that is actually or constructively received by the later of:**
 - (a) 2½ months (15th day of third month) after end of service provider's first taxable year in which amount was no longer subject to a substantial risk of forfeiture; or**
 - (b) 2½ months (15th day of third month) after end of service recipient's first tax year during which amount was no longer subject to a substantial risk of forfeiture.**
 - (2) Applied on a payment by payment basis**
- e. Certain Stock Options**
 - (1) Incentive stock options and an option granted under an employee stock purchase plan under IRC 423.**
 - (2) Option on service recipient's stock where exercise price is never less than the fair market value as of the date of the grant of the option.**
 - (a) Broader definition of service recipient for this purpose if part of controlled group**
 - (b) Regulations contain detailed rules for determining fair market value**
 - (c) Watch out for modifications, extensions, renewals, substitutions and assumptions of stock rights which in certain circumstances will be considered the grant of a new option for 409A purposes.**

f. Certain Stock Appreciation Rights

(1) Must satisfy each of the following:

- (a) The compensation payable under the right cannot be greater than the spread between the fair market value of the stock on the date of the grant of the right and the value of the stock on the date of exercise of the right.**
- (b) The exercise price may never be less than the fair market value of the underlying stock on the date of the grant of the right.**
- (c) The right does not include any feature for the deferral of compensation other than deferring of income until the exercise of the right.**

(2) Fair market value is determined in accordance with the regulations governing stock options.

g. Restricted property

- (1) No deferral of compensation merely because value of property excluded from income because it is not vested (or in includible because of an election under IRC 83(b)).**

h. Certain partnership arrangements

- (1) Principles of Notice 2005-1 continue to apply until later guidance is issued.**
- (a) Issuance of profits interest in connection with the performance of services is not a deferral of compensation under this notice.**
 - (b) Generally, guaranteed payments under IRC 736 would not be subject to 409A (unless those payments are subject to self-employment tax under IRC 1402(a)(10))**

D. Requirements For Arrangements Subject to 409A

1. Material Terms of Arrangement In Writing

- a. Can be set forth in more than one document
- b. Have until December 31, 2008 to satisfy this requirement

2. Deferral Elections

- a. **Timing and form of the distribution must be specified at time of initial election.**
- b. **Arrangement providing the service provider with election to defer**
 - (1) **Generally, election must be irrevocable before the beginning of the year in which the services are performed**
 - (2) **Initial election upon first becoming eligible to participate in the arrangement can be made within 30 days after becoming eligible (but applies only to compensation for services performed after the election).**
 - (a) **It is an initial eligibility election only if it is the first time the service provider is eligible to participate in any plan of the employer of the same type**
 - (3) **For certain performance based compensation over a performance period of at least 12 months, election can be made up to 6 months before the end of the performance period. Amount of compensation cannot be readily ascertainable at the time of the election**
- c. **Arrangement that does not provide service provider with election to defer**
 - (1) **The time and form of payment must be established in the document by the later of:**
 - (a) **when the legally binding right to the payment first arises, or**
 - (b) **by the time that the service provider would have been required to have made an election if the arrangement provided for such an election.**

d. Subsequent changes in the timing or form of payment

- (1) A plan or arrangement may allow a change in the time or form of the distribution but need not do so. If it does,**
 - (a) Plan must provide that the change will not apply until at least 12 months after the subsequent election is made.**
 - (b) If the election relates to a payment to be paid as a result of a separation from service or at a specified time or fixed schedule or a change of control, the plan must require that the payment be deferred for a period of not less than 5 years from the date it would otherwise have been paid.**
 - (c) If the change is related to a payment due at a specified time or fixed schedule, the change must be made at least 12 months before the payment is scheduled to be paid.**
- (2) Such a change is not an acceleration even if payment occur earlier than under the original payment form or time**
- (3) Certain changes are not considered a change in the form or time of payment under the regulations, such as the change in a designated beneficiary for an annuity payment, or the change from one form of annuity to another where the actuarial value is the same**
- (4) Payment may be delayed under certain conditions if a deduction would not be permitted under IRC 162(m) (\$1 million deduction limit), or if payment would violated federal securities laws or other laws, without the delay being treated as a subsequent deferral election**
- (5) Adjustments to amounts deferred under arrangements linked to qualified plans due to the terms of the qualified plan or the limits applicable to the qualified plan will not be a subsequent deferral election as long as there is no change in the timing or the form of payment under the arrangement.**

3. Distribution Options

a. Deferred compensation arrangement may allow distributions only on certain specified events. Arrangement does not need to allow payment at each of those events. It can select one or more of the following:

(1) Specified date or fixed schedule (specified at the time of deferral either by the election of the participant or the terms of the arrangement).

(a) Must be an objectively determinable date or fixed schedule at the time of deferral election.

(2) Separation from service

(a) Defined in detail in the regulations. Certain leaves of absence will not constitute a separation from service. Some flexibility under the regulations to allow part-time employment while treating the change in status as a separation.

(b) Special rule for key employees of a public company. Separation from service does not occur until at least 6 months after date of actual separation.

Key employee definition ties back to certain qualified plan rules.

(c) Regulations use a broader definition of employer group for purposes of the definition of a separation from service than for more general purposes in the regulations.

(3) Death

(4) Disability

(a) Regulation has its own definition of disability

(5) Change in ownership or control

- (a) **Substantial detail in the regulations about what constitutes a change in the ownership of the corporation, a change in effective control of the corporation or a change in substantial ownership of the assets of the corporation that will qualify to allow a distribution.**
- (6) **Unforeseeable emergency**
 - (a) **Regulations define as a severe financial hardship resulting from events that are unforeseen and beyond the control of the employee. Distributions limited to amounts necessary to satisfy the emergency (including tax payments).**
- b. **Payment date upon occurrence of the payment event must be specified (can be a payment schedule that is objectively determinable and nondiscretionary)**
- c. **Except for very limited exceptions, plan or arrangement can specify only one form and time of payment with respect to a bucket of deferred compensation payable with respect to a type of permissible payment event.**
 - (1) **In other words, arrangement could provide one time and form of payment upon a separation from service (installments over five years for example), while providing for a lump sum payment upon death.**
 - (2) **Regulations provide some guidance about what constitutes a form of payment (and what changes will result in a change in the form of payment).**
- d. **Substitution Rule**
 - (1) **Absent an exception in the regulations, payment of amount as a substitute for deferred compensation will be treated as payment of the deferred compensation (which means that the substitute needs to satisfy the 409A limitations applicable to the deferred compensation or 409A will be violated).**
 - (2) **Facts and circumstances test. The regulations apply certain presumptions. Language of the regulation is broad.**

4. Prohibition on Acceleration of Deferred Compensation Payments

- a. Except in very limited circumstances, the payment of deferred compensation may not be accelerated by agreement or otherwise**
- b. Exceptions that may be provided by the plan include the following:**
 - (1) Small amount that does not exceed the elective contribution limit of 401(k) plans (\$15,500 in 2008)**
 - (2) QDROs**
 - (3) Payment of certain taxes.**
 - (4) Avoid violation of a governmental ethics law or conflicts of interest law**
 - (5) Cancellation of deferral election due to unforeseeable emergency or a hardship as defined in the 401(k) regulations.**
 - (6) Certain plan terminations or liquidations in the context of bankruptcy or corporate dissolution or change of control of the corporation**

5. Funding Restrictions

- a. Taxable event occurs if a service recipient transfers assets to an offshore trust (even if the trust is otherwise subject to the claims of the service recipient's creditors) used for purposes of paying deferred compensation.**
- b. Taxable event occurs if the service recipient transfers property or funds a trust (including a trust that is otherwise subject to the claims of the service recipient's creditors) in connection with a change in the service recipient's financial condition.**

E. Application to Certain Types of Deferred Compensation

1. Severance pay

- a. Certain severance pay plans excluded from 409A**
 - (1) Collectively bargained plan**

- (2) **Involuntary separations (including a good reason termination) and window programs where amounts paid will not exceed two times the annualized compensation for the prior year that does not exceed the compensation limit applicable to a qualified plan and is paid by the end of the second taxable year following the year of separation.**
- 2. **In-kind benefit commitments, continuing insurance coverage and reimbursements**
 - a. **Certain exclusions from 409A are available**
 - (1) **Payments of otherwise deductible business expenses or reasonable outplacement or moving expenses available for a limited time under a separation pay plan**
 - (2) **Post-termination reimbursement of medical expenses during the COBRA period under a separation pay plan**
 - (3) **Reimbursements for year of separation that are less than the limit applicable to elective deferrals under a tax-qualified plan (\$15,500 in 2008)**
 - (4) **Certain indemnifications and liability insurance coverage; settlement of bona fide legal claims; and certain educational benefits**
 - (5) **Remember that non-taxable benefits are not subject to 409A, so continuing medical coverage that is not taxable under IRC 105 and 106 is outside of 409A.**
 - b. **Structuring if subject to 409A**
 - (1) **Use defined payments (i.e. agreement to provide a regular schedule of payments) that can be used by former employee to pay insurance premiums**
 - (2) **Special rule in regulations for reimbursement arrangements**
 - (a) **Will satisfy the fixed schedule requirements of 409A if:**

- (i) expenses eligible for reimbursement are clearly and objectively defined
- (ii) Available during a defined time period
- (iii) Amount reimbursed in one year cannot impact amount to be reimbursed in another year
- (iv) Payment no later than the end of the year after the year in which the expense was incurred
- (v) Cash or other benefit cannot be substituted for reimbursement right

(3) Special rule in regulations for tax gross-ups

III. Grandfathered Benefits; Current Transition Relief

A. Amounts Deferred before January 1, 2005

- 1. If earned and vested before January 1, 2005, amounts (and subsequent earnings) are exempt from 409A (unless the arrangement is materially modified on or after October 3, 2004).
- 2. Vesting for this purposes means amount is not subject to a substantial risk of forfeiture and is not subject to a requirement to perform further services.

B. Compliance Deadlines and Transition Relief

- 1. Effective date of final regulations has been extended to January 1, 2009.
 - a. Plan amendments in compliance with final 409A regulations are required by the end of 2008, effective January 1, 2009
 - b. Amendment does not need to be retroactive. Plans terminating before 2009 need not be amended to comply with 409A
 - c. Plans must operate in compliance with 409A beginning January 1, 2005

- (1) For 2008

- (a) Where Notice 2005-1 is inconsistent with the final regulations, plans can choose which guidance to follow.
- (b) For issues not addressed in Notice 2005-1 or final regulations, sponsors can rely on a reasonable, good-faith interpretation of the statute
- (c) Operating in compliance with the proposed regulations in not good faith compliance during 2008.

(2) Before 2008

- (a) Compliance with proposed or final regulations is good-faith compliance with the statute
- (b) Where there are inconsistencies among Notice 2005-1, proposed regulations and final regulations, plan can choose which guidance to follow.

2. Special Rule for Changes in Time or Form of Payment

- a. Plans may provide or permit participant elections to change the time or form of payment on or before December 31, 2008
- b. Change during year cannot result in amounts being paid in that year or change amounts that would otherwise be paid in that year

3. Special Deferral Election Rule for Short-Term Deferrals

- a. Deferral election for compensation attributable to 2007 or 2008 otherwise payable after the year-end but before March 15 of the following year may be made by the end of the year to which the compensation is attributed.

4. Payment Elections Linked to Qualified Plan

- a. May continue to link payment election under the nonqualified arrangement with the election under the qualified plan through December 31, 2008, provided the time and form of payment is made in accordance with the terms of the nonqualified plan as in effect on October 3, 2004.

5. Special Transition Relief for Stock Options and Stock Appreciation Rights

- a. May amend outstanding stock options and stock rights subject to 409A to fixed payment terms (or allow elections to do so) that are consistent with 409A if amendments or elections are made by December 31, 2008. (Subject to the same rule applicable to changes in the time and form of payment that change cannot move amounts into the current year or postpone amounts that would otherwise be paid in that year).**
- b. Substitution of a non-discounted stock option or stock appreciation right for a discounted one is generally permitted through December 31, 2008.**
 - (1) Must not result in the cancellation of a deferral in exchange for cash or vested property in the same year.**
 - (2) This extension does not apply to discounted options covered by 409A by public companies and held by those subject to the disclosure requirements Section 16(a) of the 1934 Act where the discount was not timely reported on financial statements—those awards needed to be corrected by the end of 2006.**

IV. IRS Limited Relief For Operational Failures (IRS Notice 2007-100)

A. Correction of Operational Errors in Taxable Year of Failure

- 1. Must satisfy the following:**
 - a. Must be operational (not a plan terms failure) and unintentional (higher standards beginning in 2009—similar failure has not occurred in the past unless reasonable steps established and failure occurred despite diligent efforts)**
 - b. Cannot relate to the exercise of a stock right**
 - c. Corrected during the same taxable year in which it occurred**
 - d. Not listed as an abusive transaction**
 - e. Reasonable steps to ensure that same failure will not reoccur**