“An Internal Revenue Code Section 409A Primer”

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“Executive Compensation: What’s Changed
In Light of Corporate Scandals?”
An Internal Revenue Code Section 409A Primer

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The American Jobs Creation Act of 2004 was signed into law on October 22, 2004. It created a new Section 409A of the Internal Revenue Code (“409A” and the “Code” respectively). 409A affects nonqualified retirement plans and other deferred compensation arrangements. It seeks to eliminate abuses related to election timing, distribution timing, and the ability to take accelerated payments under such plans. The new Code section provides generally that, unless certain requirements are met, amounts deferred under a nonqualified deferred compensation plan will be currently includible in income and subject to an additional 20% excise tax.

409A is broad in scope. It applies to any plan or arrangement (including an individual agreement) that provides for the deferral of compensation. Types of plans covered include the following:

- Supplemental executive retirement plans
- Salary and bonus deferral arrangements
- Deferred commission arrangements
- Excess benefit plans
- Code Section 457(f) plans (“ineligible” 457 plans for government and tax exempt entities)
- Certain severance pay plans
- Deferred compensation plans for directors and non-employees
- Certain equity plans
- Litigation settlements granting deferred compensation
- Any other arrangement or plan that has the effect of deferring compensation relating to one taxable year into a subsequent taxable year (other than amounts paid within 2 1/2 months of the end of the year to which service relates)

Despite its broad reach, 409A does not apply to tax qualified retirement plans (Code Section 401(a) qualified plans, 457(b) plans, 403(a) and (b) annuity plans, SEPs, SIMPLEs and government excess benefit arrangements under Code Section 415(m)) or to bona fide vacation, sickness or disability, and death benefit plans.

Arrangements in effect prior to October 4, 2004 that are not materially modified after that date will continue to be subject to pre-existing tax rules to the extent that deferred compensation is earned and vested as of December 31, 2004.

Since the enactment of 409A, Internal Revenue Service (the “IRS”) Notice 2005-1 and proposed regulations have been issued elaborating on the requirements of 409A.

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Notice 2005-1

409A initially applied to amounts deferred after 2004 (as well as previously deferred amounts that were not yet earned and vested before the end of 2004). The IRS first issued guidance under 409A in Notice 2005-1 released on December 20, 2004. Notice 2005-1 provided transitional relief during 2005 and generally gave taxpayers until December 31, 2005 to bring their written plan documents into compliance with 409A. The notice also provided that “good faith compliance” was adequate under the standards set forth in the notice. However, the most recent, and most thorough, guidance with respect to 409A are the recently issued proposed regulations.

Proposed Regulations

On September 29, 2005 proposed regulations on deferred compensation under 409A were issued. This summary focuses primarily on the proposed regulations because they represent the most recent authority with respect to 409A. The proposed regulations provide that they may be relied upon until final regulations take effect on or after January 1, 2007.

Extension of transition relief for some issues discussed in Notice 2005-1

The proposed regulations purport to take effect on or after January 1, 2007. However, as mentioned above, current reliance on the rules is acceptable. Initially, Notice 2005-1 issued transition rules. The proposed regulations retain some, but not all, of those transition rules and extend the compliance period to December 31, 2006. Of greatest significance are the following extensions:

- Plans adopted before December 31, 2006 must be amended on or before December 31, 2006 either to conform to 409A or to provide for compensation that is not covered by 409A. The plan must still be operated in good faith compliance with the provisions of 409A.

- A plan adopted on or before December 31, 2006 will be treated as operating in good faith compliance with 409A if it is operated in accordance with Notice 2005-1 or, to the extent an issue is not addressed in Notice 2005-1, if it is operated in accordance with a good faith, reasonable interpretation of 409A. Compliance with the proposed regulations also qualifies as good faith compliance.

- The period during which a plan may be amended and during which a service provider may be permitted to change payment elections is extended until December 31, 2006, except that an employee cannot, in 2006, change payment elections with respect to amounts that the employee would receive in 2006 or change payment elections to cause payments to be made in 2006.

- As mentioned above, elections under a tax-qualified plan that govern the time or form of payment under a nonqualified deferred compensation plan can continue to apply with respect to distributions made or commencing on or before December 31, 2006, provided that the election is made in accordance with the terms of the nonqualified plan as in effect on October 3, 2004.
**General Operation of 409A - Deferrals**

Generally, 409A penalizes improper deferrals of compensation by imposing heavy tax consequences. However, under 409A, as confirmed by the proposed regulations, certain short term deferrals are exempt from the stringent requirements. Amounts that must be paid soon after being earned are not subject to 409A, even if the award covers several years of service. Notice 2005-1 provided that there is no deferral of compensation subject to 409A if the terms of the plan require payment by, and an amount is actually or constructively received by the employee by the date that is 2 1/2 months from the end of the employee’s year in which the amount is no longer subject to a substantial risk of forfeiture. The proposed regulations also include this rule and provide further that there need not exist any actual plan provision that requires payment by the relevant deadline so long as the payment is actually made by the deadline. But if the plan does include a provision requiring payment by a certain date the such payment is not made by that date, the payment can be made through the end of the tax year. The proposed regulations also clarify that payments that otherwise would qualify for the short-term deferral exception may be deferred, provided that (1) any such deferral election is made at least 12 months before the date on which the substantial risk of forfeiture lapses and (2) payment is deferred to a date at least 5 years after the date on which the substantial risk of forfeiture lapses. The proposed regulations make clear that 409A does not preclude standing deferral elections (e.g., where a deferral election remains effective for future periods unless and until changed by the employee), so long as the election becomes irrevocable with respect to future compensation no later than the last permissible date that an affirmative initial deferral election could have been made with respect to such compensation.

Several additional points of interest with respect to 409A include the following:

- **Performance-Based Compensation**: 409A provides that in the case of any performance-based compensation based on services performed over a period of at least 12 months, a participant’s initial deferral election may be made no later than 6 months before the end of the period. The proposed regulations define performance-based compensation as compensation the payment of which is contingent on the satisfaction of preestablished organizational or individual performance criteria.

- **Separation from Service**: The proposed regulations provide that an employee experiences a separation from service for purposes of 409A if the employee dies, retires or otherwise has a termination of employment with the employer. Whether or not a termination of employment occurs will generally be based on the particular facts and circumstances.

- **Special Delay for Key Employees**: 409A provides that payments to a “key employee” upon a separation from service from a corporation whose stock is publicly traded on an established securities market must be delayed at least six months following the separation from service. For these purposes, a key employee is generally one of the top 50 officers.

- **Three Situations When Employers Can Pay Out Deferrals Immediately**: First, where an employer ceases providing a certain category of nonqualified deferred compensation plans altogether and the employer terminates all such plans with respect to all participants. Second, during the 30 days preceding or 12 months following a change in control of a corporation (but only if all substantially similar arrangements of the
employer are terminated). Third, in the case of certain corporate dissolutions or with the approval of a bankruptcy court.

- **Linked Plans**: The proposed regulations provide generally that neither the amendment of a qualified plan to increase or decrease benefits nor the cessation of future accruals under the qualified plan is treated as a deferral election or an acceleration of a payment under the nonqualified plan.

409A’s Impact on Equity Awards

Another important feature of 409A discussed in the proposed regulations is the section’s impact on equity awards. Notice 2005-1 and the proposed regulations, generally provide that a discounted stock option would be subject to 409A (equity awards would fail to meet 409A’s stringent requirements, in particular the rules regarding distributions, since optionees generally have the right to elect when to exercise the option). Both the notice and the proposed regulations provide that a nondiscounted stock option will not be treated as deferred compensation subject to 409A. A nondiscounted stock appreciation right (“SAR”) will also not be treated as deferred compensation. However, there are restrictions on the type of equity permitted under this exception. The proposed regulations also restrict modifications, extensions or renewals of previously granted options and SARs. Modifications will generally result in the treatment of the equity award as a new grant. Extensions or renewals may result in the option or SAR being treated as though it had originally been granted with a deferral feature and thereby subjecting it to 409A as of the original date of grant. The proposed regulations provide that the term “modification” means any change in the terms of the stock right that may provide the holder of the right with a direct or indirect reduction in the exercise price of the stock right, or an additional deferral feature, or an extension or renewal of the stock right, regardless of whether the holder in fact benefits from the change in terms. There are, however, “deal exceptions” for these rules. The proposed regulations provide that the conversion of options and SARs in the corporate merger and acquisition context will not result in an impermissible modification if the conversion satisfies the requirements of Treas. Reg. § 1.424-1 (which provides rules for the substitution of incentive stock options - incentive stock options are not subject to 409A unless they are modified so as to lose ISO status). As mentioned above, discretionary change in control cash-outs are also permitted. Discretionary distributions are permissible between 30 days before and 12 months following a change in control.

Application to Severance Plans

Separation pay arrangements, i.e., severance plans, are generally subject to 409A. However, the proposed regulations generally exempt arrangements where severance is paid upon actual involuntary separation from service or pursuant to a window program and (1) the entire amount of payments to any employee does not exceed 2 times the employee’s annual compensation or, if less, 2 times the limit on annual compensation that may be taken into account for contributions under qualified plans (set forth in Section 401(a)(17) of the Code), in each case for the year prior to separation, and (2) all payments must be made by no later than the end of the second calendar year following the year in which the termination of service occurs. These provisions do not apply to termination for good reason. These limitations generally are consistent with the safe harbor under which severance plans may be treated as welfare plans (and not pension plans)
under the Employee Retirement Income Security Act of 1974. This exception may not be applied to individuals earning more than the compensation limitation set forth in Section 401(a)(17) of the Code. With the proposed regulations’ exceptions, the result is that payments that fall within these guidelines will not be subject to 409A, thus the requirement for a 6-month delay in payments to key employees will not apply.

Conclusion

It may take some time to adjust to compliance with 409A. Like 2005, 2006 will be a year that employers face many new decisions with respect to deferred compensation. Taking into consideration the following points should help employers craft their compliance strategies.

• Continue to operate your 409A plans in good faith compliance with the statute, the notice and/or the proposed regulations.

• Start deciding how you will get plans into documentary compliance. The proposed regulations extend the transition rules allowing amendment of plan rules to bring the documentary compliance through the end of 2006. You will need to decide whether to amend the plans to fit within one of the 409A exemptions (for example, the short-term deferral exemption), or, if that is not feasible or desirable, how you are going to amend the plan to fit within the 409A requirements. There are a number of choices that will need to be made regarding items such as distribution events, payment terms and acceleration events. Because many of the changes will be administratively difficult to implement or will require consent from plan participants, the process should be started immediately.

• If a public company, keep in mind corporate governance requirements and applicable SEC disclosure requirements that may be triggered by changes made to plans and arrangements as a result of 409A.

This summary does not and is not intended to cover all of the provisions of 409A or to provide guidance with respect to individual circumstances. If you have questions regarding the application of 409A to your plans, please contact your employee benefits legal counsel.