SPOTTING ISSUES UNDER SECTION 409A: PERSPECTIVE AND PRACTICE TIPS

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It is rare that a patient visiting a physician accurately announces his or her own final diagnosis or appropriate treatment regimen. Similarly, it is atypical, in an attorney's or accountant's practice, for a client to self-present with a fully articulated assessment of the precise type of Section 409A counsel or review appropriate to an anticipated transaction or personnel decision.[1] Indeed, many clients are unaware of the very of existence of Section 409A, let alone a Section 409A issue in the matter at hand, until a professional assists in identifying it. And identifying it is only half the battle. Section 409A, together with related guidance and regulations, presents as "comprehensive and reticulated" a statutory scheme as found in ERISA.[2] For almost every rule in Section 409A, an exception, and sometimes multiple exceptions, can apply. The intricacies of the subject matter should not inhibit attorneys or accountants from becoming more familiar with some of the more common nonqualified deferred compensation issues and errors that arise, however. On the contrary, it is the broad reach and the complexities of this Code section that makes it imperative for practitioners to endeavor to become more familiar with its purview. The goal of this article is not to describe every feature of Section 409A, but rather to draw attention to select issues that lend themselves to relatively easy identification.

For the legal or tax practitioner, as for the physician, proper diagnosis requires a base of knowledge, a familiarity with common indicators, and the strategic use of interactive discussions and questions aimed at uncovering all relevant facts. By presenting an overview of the context in which Section 409A arose and how it functions, this article will arm you with information useful in defining the laws and policy relevant to deferred compensation. By highlighting the key types of agreements, and the specific provisions within such agreements, that most commonly implicate or violate Section 409A, the discussion will empower you to identify the words and situations that should signal you to suspect that Section 409A's complex rules are at play. Provided with these insights, you will be better able to ask the relevant questions needed in order to confirm your diagnosis. From there, your judgment as to your

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familiarity with all aspects of the topic will be the guide as to whether you will oversee the treatment plan needed to structure (or correct) agreements in a manner to ensure full compliance with the rules' requirements or whether the matter should be referred to a specialist.

Historical Perspective

Deferred Compensation before Section 409A

Prior to Section 409A's 2004 enactment, the determination of when amounts deferred under a nonqualified deferred compensation arrangement became includable in income depended on the facts and circumstances of the arrangement. No single Code section governed the taxation timing. Income inclusion was governed by a variety of Code sections and common law tax principles, including the constructive receipt and the economic benefit doctrines.[3]

Given the lack of a principal locus of tax authority, it is perhaps no surprise that rulings by the IRS and the courts did not always reach consistent conclusions, under similar facts, as to the permissibility of various arrangements for successfully deferring the taxation of compensation.[4] In some cases it litigated, the IRS attempted to aggressively apply constructive receipt theories to achieve the current taxation of deferred amounts under disputed arrangements. Court rulings generally tended to be much more permissive. In early 1978, the IRS proposed a regulation that would have included in current income all amounts deferred at the employee's (rather than employer's) option.[5] Congress acted quickly to thwart the proposal, and included a provision in the Revenue Act of 1978 that prohibited the IRS from issuing regulations any more restrictive than those currently in effect. This 1978 "freeze" of the IRS's regulatory authority inhibited IRS influence on aggressive deferred compensation practices.

For many years thereafter, sponsors of nonqualified deferred compensation plans, as well as their advisors, "lived with a mild form of regulatory schizophrenia."[6] While written IRS guidance sought to constrain plan design, limit deferral election options, and discourage any approach that permitted executives to simultaneously defer tax and enjoy greater priority than the employer's creditors, enforcement of the rules was minimal. The common flouting of existing IRS rules led to something of a "wild west" atmosphere. The gap between the IRS view of how deferred compensation should be regulated and the practices that, in fact, became widespread among plan sponsors led to the routine ability of executives to postpone both the receipt and taxation of compensation, while at the same time enjoying unprecedented levels of authority, flexibility, and security.[7]

One of the potentially abusive practices that became commonplace during this period included the use of so-called "haircuts." Under a haircut provision, a participant in a deferred compensation plan was permitted to elect to receive a distribution earlier than scheduled, provided that such election caused the participant to

[1] Unless otherwise indicated, all Section and Code references are to the Internal Revenue Code of 1986, as amended.

[2] *Nachman Corp.* v. *PBGC*, 446 U.S. 359, 361 (1980) (identifying ERISA as "a 'comprehensive and reticulated statute,' the product of a decade of congressional study of the nation's private employee benefit system.").

[3] Applicable Code sections and additional doctrines included Sections 83, 402(b), 403(c), 451, the cash equivalency doctrine, and the assignment of income doctrine. See, e.g. H. Rep't. No. 108-755, 108th Cong. 2d Sess. 706 (2004) (Conference Report); Notice 2005-1, 2005-1 CB 274.

[4] Compare and contrast, for example, the results in *Palmer*, TCM 2000-228, 80 T.C.M. (CCH) 101 (2000) with *Veit*, 8 TC 809 (1947), *acq*., 1947-2 CB 4 and *Oates*, 18 TC 570 (1952), *aff'd*, 207 F.2d 711 (CA-7, 1953), *acq*., 1960-1 CB 5. In *Palmer*, an independent contractor was found to be in constructive receipt of fees owed paid to him for services after 30 days, because the contract provided that his invoices would either be paid within 30 days of receipt or "deferred to a mutually agreed upon future date." In both *Veit* and *Oates*, on the other hand, executives were allowed to make last-minute deferrals of an imminent payment event for one year and nine years, respectively.

[5] Bostick, et al., "Ten New Developments You Need to Learn—American Jobs Creation Act of 2004: Executive Compensation and Employee Benefits Provisions," at 1, Sutherland, Asbill & Brennen, LLP, Mar. 1, 2015, http://apps.americanbar.org/buslaw/newsletter/0035/materials/pp1.pdf.

[6] Bianchi, "The (Section 409A) Elephant in the (Deferred Compensation) Room—Adjusting to New Realities After the American Jobs Creation Act of 2004," in *New York University Review of Employee Benefits and Executive Compensation* (2007), Vol. 2, Ch. 15, page 15-4.

[7] *Id*.

[8] The theory behind the haircut was that the forfeited benefit constituted a substantial risk of forfeiture that prevented the application of constructive receipt until such time as the reduced benefit was paid.

[9] Oppel, Jr. and Sorkin, "Enron's Collapse: The Overview; Enron Corp. Files Largest U.S. Claim for Bankruptcy," N.Y. Times, Dec. 2, 2001. This record was lost less than a year later, when WorldCom filed for bankruptcy. See, e.g. Beltran, "Worldcom Files Largest Bankruptcy Ever," CNN/Money, July 22, 2002.

[10] Staff of Joint Comm. on Taxation, 108th Cong., "Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations," JCS-3-03, (Comm. Print 2003).

[11] Oppel, Jr., "Employee's Retirement Plan Is a Victim as Enron Tumbles," N.Y. Times, Nov. 22, 2001, http://www.nytimes.com/2001/11/22/business/employees-retirement-plan-is-a-victim-as-enron-tumbles.html; Kennedy, "A Primer on the Taxation of Executive Deferred Compensation Plans," 35 J. Marshall L. Rev. 487, 491 (2002).

[12] Notice 2005-1, 2005-1 CB 274.

forfeit a portion (typically equal to 10%) of the amount distributed.[8] Another frequent practice during this time included the use of offshore Rabbi Trusts to set aside deferred compensation amounts. This had the effect of technically avoiding the participant's constructive receipt of the funds, because Rabbi Trusts remain subject to an employer's creditors. Practically, however, such funds became impossible for creditors to access. The boundaries of deferred compensation practice were also pushed in the form of financial health triggers. Modeled on the type of financial triggers routinely incorporated into bank loan covenants, deferred compensation arrangements structured around a financial trigger provided that if insolvency appeared likely, the plan would automatically distribute deferred amounts to its executives.

And Then Came Enron

Section 409A was added to the Code by the American Jobs Creation Act of 2004. The political will to enact it arose as a direct response to events that happened leading up to the late 2001 collapse of Enron, the energy commodities company headquartered in Houston, Texas. The company's accounting gimmicks and misdeeds led it to file the then largest corporate bankruptcy in U.S. history.[9]

A 2003 report by the Joint Committee on Taxation noted that Enron executives had deferred more than $150 million under Enron's nonqualified deferred compensation plans. More than $53 million in payments from these plans were accelerated and paid out in the form of haircuts shortly before the bankruptcy filing.[10] Once the company's financial problems were made public, however, Enron shares lost all their value. Rank and file employees were unable to cash out of company stock in the company's 401(k) plan. In contrast to Enron's executives, many company employees lost their entire life savings.[11] To curb these abuses, staff members of the Joint Committee on Taxation recommended developing rules to require current inclusion in income for deferred compensation arrangements that "give taxpayers effective control over the amount deferred." Recommendations also centered on limiting the ability of taxpayers to accelerate distributions of deferred compensation.

Section 409A

As noted, Section 409A was enacted as part of the American Jobs Creation Act of 2004. Deceptively concise as a statute section standing alone, Section 409A's full scope encompasses the hundreds of pages of subsequently issued IRS guidance and related Treasury regulations. The vast reach of the guidance and regulations, as well as the broad definition of "deferred compensation," makes Section 409A pervasive in its impact on nearly all deferred compensation arrangements.

The IRS has clarified that Section 409A expands upon and partially codifies, but does not supersede, pre-existing tax law. Consequently, even if deferred compensation is not required to be included in income under Section 409A, it may nevertheless be required to be included under one or more of the other applicable sections or principles.[12]

Contemporary legislative concerns with deferred compensation abuses were squarely addressed in Section 409A, which explicitly prohibits the use of haircuts, offshore trusts, and financial health payment triggers. More broadly, Section 409A focuses on the following areas, for which compliance must be reflected in a written document in existence prior to its effective date:

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1. *Initial Deferral Elections.* Generally, a service provider's election to defer compensation with respect to services performed for a tax year must be made no later than the last day of the preceding tax year. To be valid, an election must generally be irrevocable and must specify the amount of the deferral, as well as the time and form of its future payment. Limited exceptions are available. New employees who begin performing services mid-year, for example, may make an initial deferral election within 30 days after becoming eligible to do so. An election to defer performance-based compensation (such as a bonus based upon the achievement of annually specified criteria), may be made up to six months before the end of a 12-month performance period.

2. *Subsequent Deferral Elections.* Any election made with respect to an amount already deferred under an initial deferral election must be made at least 12 months in advance of the scheduled payment date, and must have the effect of delaying the payment timing by at least

five years. Because any subsequent deferral election does not take effect until 12 months after it is made, an election made, say ten months prior to a previously scheduled fixed date, and intended to delay the timing of a the deferred payment by two years, will not be effective. In this example, the initial election will govern and payment will be considered made on the originally elected date.

3. *Restrictions on Payment Events.* Distributions under Section 409A may be made only upon the occurrence of specified payment events, which are: (a) separation from service; (b) disability; (c) death; (d) a specified time or fixed schedule; (e) a change of control; and (f) an unforeseeable emergency. At the discretion of the drafter, payments may be permitted upon the "earlier of" or the "later of" multiple permitted payment events. The form of a future payment (for example, in a lump sum in the event of death, and in installments upon a separation from service) must be specified in the written document.

4. *Restrictions on Acceleration.* Section 409A generally prohibits the acceleration of payment timing, with restrictions permitted only under limited circumstances.

5. *Definitions.* Many of the key definitions used under Section 409A are explicitly prescribed by Section 409A and the regulations. In particular, plans subject to Section 409A must use the required definitions for such terms as "separation from service," "change of control," and "disability."

Defining Deferred Compensation and Related Terms

Deferred Compensation

The term "deferred compensation" appears in multiple different Code sections,[13] but is specifically defined nowhere in the statutes. Instead, separate definitions with respect to the various sections have evolved in the regulations. For this reason, it is important to be clear about what is meant by the term under Section 409A. Section 409A contributes to an understanding of the definition by enumerating what deferred compensation *is not.*[14] Specifically, a nonqualified deferred compensation plan is any plan, including any agreement or arrangement "that provides for the deferral of compensation, *other than* (A) a qualified employer plan and (B) any bona fide vacation, leave, sick leave, compensatory time, disability pay, or death benefit plan."[15] Under applicable regulations, deferred compensation subject to Section 409A is more directly and broadly defined: "a plan provides for the deferral of compensation if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable to (or on behalf of) the service provider in a later taxable year."[16]

Put simply, a nonqualified deferred compensation plan or arrangement is a contractual agreement between an employer and its executive to defer the payment (and taxation) of a portion of the executive's presently earned compensation to a later year. Instead, or in addition, the agreement may provide that the employer will make future payments to the executive of presently credited employer contribution amounts.[17] Promises regarding deferred compensation range greatly in complexity. While few hard and fast norms apply, some types of arrangements are more common with smaller employers or start-up companies, while others are typically (but not exclusively) offered by larger employers. On a spectrum from simple to more complex, promises constituting deferred compensation may exist merely as a short sentence in an employment agreement, may be set apart as a stand-alone agreement between the employer and the executive, or may take the form of a plan document with numerous executive participants, perhaps with multiple award agreements, each with terms customized for an individual executive. Some programs involve multiple awards made to one or more individuals over multiple different years. Vesting schedules may apply and may differ by individual participant. Arrangements may anticipate that future payments are settled in cash or in stock under various phantom stock plans, or under certain stock appreciation rights or stock options. Traps for the unwary can exist in annual bonus programs, severance agreements, certain post-retirement medical expense payment arrangements, change in control agreements, and discounted stock options, just to name a few examples.

One thing that is *not* required for an amount to constitute deferred compensation subject to the requirements of Section 409A is that the future payment be guaranteed or offered without attached conditions. On the contrary, the mere possibility that a payment in a future year, but relating to current-year services, may occur is enough to bring the promise within the broad

scope of Section 409A. This is true even if it is impossible to determine at the time that the promise is made whether a future contingent event will or will not occur.

In order to avoid taxation at the time of deferral under the doctrine of constructive receipt (including as codified by Section 409A), nonqualified deferred compensation is explicitly offered without the kinds of guarantees and security afforded to participants of qualified deferred compensation plans, such as 401(k)s. While 401(k) plan assets are required by law to be, at all times, protected from the employers' and employee's creditors, nonqualified deferred compensation plan assets must remain, until paid to the participant, the property of the employer and subject to the employer's creditors. A key component of avoiding current taxation is avoiding any funding arrangement that would guarantee the availability of deferred compensation, while also shielding the funds from the employer's creditors.[18]

Service Provider

Section 409A uniformly uses the term "service provider" to refer to the recipient of the promised deferred compensation. While a service provider is typically an executive or other valued employee or independent contractor, it is important to remember that the regulations' definition of a service provider is not limited to a human person. The service provider definition also includes a corporation, a subchapter S corporation, a partnership, a qualified personal service corporation under Section 269A(b)(1) (or a noncorporate entity that would be a qualified personal service corporation if it were a corporation) for any year in which such employee or entity accounts for gross income from the performance of services under the cash receipts and disbursements method of accounting.[19] The requirements of Section 409A, therefore, apply only to cash-basis servive providers and not to accrual-basis servive providers.

Service Recipient

Under Section 409A, "service recipient" is the term used to designate the person or entity for whom the service provider performs services. Note that the aggregation rules of Sections 414(b) and (c) apply, meaning generally that if a service provider is an employee, the service recipient (together with all persons or entities that are members of a controlled group with the service recipient) is regarded as the employer.[20]

Consequences of Violation

The penalties for violating Section 409A are significant and every effort should be made to avoid them. Unfortunately, the penalties apply regardless of the reason for a violation. Not being aware that Section 409A applied to the arrangement is not a valid defense. Failure to include proper (or exclude improper) language from a deferred compensation plan, as well as the failure to operate the plan in accordance with Section 409A's requirements, will have the same result. Namely, the affected deferral election(s) will be disregarded, and tax penalties will apply. With respect to any deferred amount not yet included in income, the executive will owe, for the tax year in which the error occurred:[21]

1. Ordinary income tax on the deferred amount (and on any earnings, if applicable), retroactive to the date of the initial deferral.
2. In addition to the regular income tax owed under item 1, above, an additional 20% tax will apply to the balance of the deferred amount.
3. Finally, a premium interest tax will apply to the total tax owed under items 1 and 2, above. The amount owed is an interest factor based on the Section 6621 underpayment rate plus one percentage point.[22] Because Section 409A viola-

[13] See, e.g., Sections 404, 409A, 457, 3121(v), and 457A.

[14] All deferred compensation discussed in this article in the context of Section 409A should be presumed to be nonqualified deferred compensation, even when it is referred to as simply deferred compensation. Both terms (nonqualified deferred compensation and deferred compensation) should be understood to be legally distinct from qualified deferred compensation, which is the domain of tax-qualified plans such as those governed by Section 401(k).

[15] Section 409A(d) (emphasis added). Regulations clarify that Sections 403(b) and 457(b) retirement accounts, as well SEP-IRAs and SIMPLE-IRAs are also excluded from the definition. Reg. 1.409A-1(a)(2).

[16] Reg. 1.409A-1(b)(1).

[17] The terms executive, employee, service provider, and participant are used interchangeably throughout this article and are intended to have the same meaning.

[18] While funded versus "unfunded" status of executive compensation arrangements is beyond the scope of this article, note that the use of grantor trusts, including Rabbi Trusts, is one common mechanism for setting aside credited funds for the purpose of providing the executive with some assurance of their future availability, while also subjecting the funds to potential claims from the employer's creditors as needed to avoid current taxation. Another possible method is for the employer to simply record the credited amounts in a notional bookkeeping account, to be paid out of general assets if and when due.

[19] Reg. 409A-1(f)(1). The regulations contain detailed rules for determining whether an independent contractor is a service provider subject to Section 409A. Reg. 1.409A-1(f)(2).

[20] Reg. 1.409A-1(g).

[21] Section 409A(a)(1).

[22] This premium interest tax is technically an additional income tax and not an excise tax or underpayment penalty.

tions require a service provider to include amounts in income in the year of the violation (rather than refilling for earlier tax years), this tax functions to take away the benefit of the earlier years of deferral.

Notwithstanding the fact that the employer, rather than the executive, is the party responsible for drafting a deferred compensation agreement and ensuring its compliance with the law, the financial burdens described above will apply solely to the executive. The employer will not escape a Section 409A violation unscathed, however. In addition to the hard feelings that will surely arise on the part of the executive, who will pay additional taxes as a result of errors in the employer's drafting or administration of the deferred compensation plan, the employer must carry out burdensome reporting obligations and pay reporting-related penalties. To the extent that a disregarded deferral involves an employee (rather than an independent contractor or other type of service provider), the employer may be deemed to have incorrectly withheld the income tax that would have been owed, but for the improper deferral. Penalties and related interest will apply.[23] An employer may also be required to correct payee statements provided to the employee. Penalties and taxes applicable to an employer in the event of a Section 409A violation include, for open years:[24]

1. In the event of a failure to file a correct Form W-2 with the IRS, a 10% tax on the aggregate amount that should have been originally included.[25]
2. The related failure to furnish a correct Form W-2 to the employee will result in another 10% tax to the employer on the aggregate amount.[26]
3. If the IRS takes the position that the failure to withhold was voluntary, conscious, and intentional, a 100% tax of the underpayment of the income on tax withholding will apply.[27]
4. Subject to reasonable cause arguments and certain cap and offset rules, separate monthly penalties apply for the failure to report and the failure to pay employment taxes on Form 941.[28]
5. In the case of failure to properly report taxes due on Forms W-2 and 941 as a result of negligence or disregard of the rules, or in the case of understatements exceeding certain percentage or dollar thresholds, additional tax penalties can apply.[29]
6. Finally, civil or criminal fraud penalties (or both) may be imposed under circumstances indicative of willful failure to collect taxes.[30]

For Section 409A violations relevant to a nonemployee, penalties will not arise with respect to tax withholding obligations. Applicable penalties may apply, however, for the twin failures to file and to furnish Forms 1099-MISC,[31] as well as for civil and criminal fraud.[32]

A key component of avoiding current taxation is avoiding any funding arrangement that would guarantee the availability of deferred compensation, while also shielding the funds from the employer's creditors.

General Exemptions

Grandfathered Plans

Deferred compensation amounts earned and vested as of December 31, 2004, under a plan document in effect as of October 3, 2004, are grandfathered and exempt from Section 409A. This exemption from 409A is lost, however, to the extent that the plan is "materially modified" on or after October 3, 2004. A "material modification" would include the addition to the plan or arrangement of any right or feature that provided a new benefit to the employee or other service provider, but not the exercise or reduction of an existing right or feature, or the termination of the plan.[33] In other words, a material modification exists when a benefit is added or enhanced (with limited exceptions), but does not generally exist when a benefit is taken away.

Short-Term Deferrals

One of the most important exemptions from the requirements of Section 409A is the short-term deferral exception. Payments made a short period after the amounts are no longer subject to a substantial risk of forfeiture are not

[23] Dodd and Schohn, "Penalties," in *Section 409A Handbook*, Ch. 28, pages 821, 822 (Olshan and Schohn, eds., 2nd ed., Bloomberg BNA, 2016).

[24] The general statute of limitations for incorrect reporting on Forms W-2 and 941 is three years. Section 6501(a).

[25] Section 6721.

[26] Section 6722.

[27] Section 6672.

[28] Section 6651.

[29] Sections 6621(a), (b)(1), and (d).

[30] Sections 6663, 6674, 7201, 7202, 7303, 7204, and 7207.

[31] Sections 6721 and 6722.

[32] Section409A(a)(1).

[33] 72 Fec. Reg. 19233, "Application of Section 409A to Nonqualified Deferred Compensation Plans" (Apr. 17, 2007); Reg. 1.409A-6(a)(4)(i)(E)(iii).

[34] Reg. 1.409A-1(b)(4).

[35] Reg. 1.409A-1(b)(5).

[36] Reg. 1.409A-1(b)(5)(i)(A).

[37] The types of arrangements mentioned above were annual bonus programs, severance agreements, certain post-retirement medical expense payment arrangements, change-of-control agreements, and discounted stock options.

considered deferred compensation. To qualify for the exception, payment must be required to be made, and actually be made, on or before the 15th day of the third month following the end of the service provider's or service recipient's tax year (whichever is later) in which the right to the payment was no longer subject to a substantial risk of forfeiture. If no payment date is specified, the payment will qualify for the short-term deferral exception if actually paid within the short-term deferral period.[34]

Safe Harbor for Stock Rights

The IRS is concerned that discounted stock options or stock appreciation rights constitute a form of deferred compensation, representing a shift of current compensation to a future tax year. A nonqualified stock option or a stock appreciation (each referred to as a stock right under the regulations) may be exempt from Section 409A's purview, however, if it is granted at no less than fair market value as of the grant date and satisfies certain other requirements.[35] To be precise, a right to a non-statutory option or stock appreciation right will not constitute a deferral of compensation under Section 409A if all of the following requirements are met:[36]

1. The option is an option to purchase common stock of the employer.
2. The exercise price is not less than the fair market value of the underlying stock on the date the option is granted.
3. The number of units subject to the stock right is fixed on the original grant date.
4. The transfer or exercise of the right is subject to taxation under Section 83 and Reg. 1.83-7 (meaning that the value of the right is included in the grantee's income in the year in which the exercise occurs).
5. The right does not include any feature for the deferral of compensation beyond the later of the exercise or disposition of the option or the time the stock acquired pursuant to the right becomes substantially vested under Reg. 1.83-3(b).

Note that because one of the requirements of the stock right safe harbor exemption is that the right must not provide for an additional deferral opportunity, any exempt stock right may become subject to Section 409A if, once vested, the employer permits the payment to be paid in a tax year other than the year of vesting. As long as any so amended stock right satisfies all applicable requirements, being subject to Section 409A is not inherently bad. Being subject to Section 409A simply means that all requirements must be thoughtfully observed. When an employer intends for a stock right benefit to become payable in a year later than the year of vesting, it should be structured to comply with Section 409A from the outset.

Spotting Issues Based upon the Type of Arrangement

Section 409A applies to all nonexempt nonqualified deferred compensation arrangements, which can exist in myriad forms. Key to spotting issues, then, is being familiar with its many forms, which, in addition to the types of arrangements mentioned in the "Defining Deferred Compensation" section above, include, but are not limited to:[37]

- Elective deferral plans, under which an employee defers his or her own money;
- Nonelective deferral plans, under which an employer provides an incentive such as a match or discretionary contribution;
- Retention incentives;
- Severance sweeteners and parachutes;
- Excess and supplemental benefit plans, such as plans permitting deferrals and/or employer contribution in excess of the Section 402(g) and Section 401(a)(17) limits on employee deferrals and annual compensation;
- Replacements for prior benefits lost by new hires;
- Restricted stock or phantom stock plans;
- Long-term incentive plans;
- Stock appreciation rights plans;
- Some 457(f) plans;
- Supplemental executive retirement plans (SERPS);
- Stock-based arrangements (other than stock options or stock appreciation rights plans that satisfy the safe harbor exemption);
- Severance agreements (with exceptions);
- Employment agreements; and
- Post-employment taxable reimbursements (with exceptions).

Spotting Issues in the Nature of the Arrangement

Some potential violations of Section 409A can be easily identified because of the context in which they arise. If your client talks to you about any arrangement, in light of a termination, a change in the level of satisfaction with a current executive, or a potential business transaction, that could result in specific payments to key employees, always check to see whether any already-existing docu-

mentation provides for payments of deferred compensation to those employees under terms different than what your client is now describing. It is always permissible to add an additional type of payment to a pre-existing deferred compensation payment. What cannot be done is to change, or take away, the existing agreement in order to replace it with another. Modifying or extending the stock underlying an existing deferred compensation plan can also be problematic.

Even if an agreement is written to comply perfectly with Section 409A's requirements (or, in the case of a stock right, if the stock right is structured to be exempt from 409A), administering the agreement differently than as provided in the document could result in the violation of Section 409A and/or the loss of the exemption for a stock right.

Substitution Payments

Substitution is a type of error that can occur in the context of negotiating changes to existing agreements. Section 409A's rule against substitutions generally provides that the time and form of payment under an agreement subject to Section 409A cannot be changed simply by forfeiting or relinquishing rights under a prior agreement for payments under a new agreement. Any such substituted agreement must preserve the same terms as to the time and form of payment as included in the first agreement. Typical examples are as follows:

Voluntary Termination of Employment. Many deferred compensation agreements provide that an employee who *voluntarily* terminates employment must forfeit any unvested deferred compensation. In a termination setting, if an employee is subject to a deferred compensation agreement with such forfeiture terms, but nonetheless receives a parting payment, a facts and circumstances question arises: was the parting payment, in fact, a subterfuge payment of the supposedly forfeited deferred compensation? Or, in the alternative, did the payment constitute a legitimately separate payment unrelated to the deferred compensation plan? Because the payment of severance money is uncommon in connection with a *voluntary* termination, the IRS presumption, in the case of payment upon a voluntary termination is that payment results "from an acceleration of vesting, followed by a payment of the deferred compensation that is subject to section 409A."[38]

Change in Original Severance Terms. If an executive's 409A-subject employment agreement describes severance payments available in the event of employment termination, but the employer later decides to enter into a change-of-control agreement with the executive, under which the executive would receive payments in a different form, or in accordance with a different schedule than described in the employment agreement, the new change-of-control agreement may be an impermissible substitution payment that violates Section 409A.

This rule can make it difficult to negotiate certain desired changes in agreements, unless another exception applies, or the arrangement(s) can be terminated in accordance with the requirements of Reg. 1.409A-3(j)(4)(ix)(C).

Modification

A modification to the terms of a stock option or stock appreciation right is "any change … that may provide the holder of the stock right with a direct or indirect reduction in the exercise price of the stock right regardless of whether the holder in fact benefits from the change."[39] When a stock right is modified, it is treated as having been granted on the day of the modification (rather than on the original grant date).[40] For this reason, a modified stock right will violate Section 409A unless, on the date of modification, it satisfies (or is exempt from) all of the Section 409A requirements.

Extension

A stock right for which the exercise period (or expiration date) is extended is generally treated as having an additional deferral feature from the original grant date.[41] An extended stock right, therefore, will always be subject to Section 409A. Assuming that the extended stock right was not originally intended to comply with Section 409A,[42] the sudden retroactive application of Section 409A to its original grant date, coupled with the fact that the extension was not likely made in accordance with the subsequent deferral rules, is highly likely to violate Section 409A,

[38] Reg. 1.409A-1(b)(9)(i).
[39] Reg. 1.409A-1(b)(5)(v)(B).
[40] Reg. 1.409A-1-(b)(5)(v)(A).
[41] *Id.*
[42] Any 409A-subject stock right can only be extended, in any event, if the subsequent deferral rules are observed.
[43] Reg. 1.409A-1-(b)(5)(v)(C)(1).
[44] Reg. 1.409A-3(b).

unless the option happened to comply with all applicable requirements on its original grant date. The regulations describe certain exceptions under which an extension of a stock right exercise period may not cause the stock right to become subject to Section 409A.[43]

Common Errors

Failure to Observe Section 409A (and its Exemptions). Intentional written and administrative compliance with the terms of Section 409A is important. Even if an agreement is written to comply perfectly with Section 409A's requirements (or, in the case of a stock right, if the stock right is structured to be exempt from 409A), administering the agreement differently than as provided in the document could result in the violation of Section 409A and/or the loss of the exemption for a stock right. Examples of problematic administrative changes include modifications (even if inadvertent or unintentional) that have the effect of:

- Accelerating the timing of exercise or payment;
- Further deferring the timing of exercise or payment without satisfying the 409A subsequent deferral rules;
- Permitting any change in the form of payment (i.e., cash instead of stock; installments instead of a lump sum payment); or
- Providing the executive or employer with the discretion to make any of these changes (even if no such changes are actually elected).

Assuming that a Phantom Stock Plan Is Exempt from Section 409A. While stock rights, if properly structured (and administered) are exempt from Section 409A, phantom stock plans are not classified as stock rights under Section 409A and are not exempt. Phantom stock plans are always subject to Section 409A, and should always be thoughtfully drafted with tax compliance in mind.

Designating a Payment Period Longer than 90-days After a Payment Event. A key policy objective of Section 409A is to limit employees' and employers' discretion over the time at which deferred compensation may be paid once it has become payable. Payment timing must be objectively specified in sufficient detail in advance. To the extent that a plan document specifies a designated period during which payment will be made, payment made during the period will be deemed to have been made in accordance with the requirements of Section 409A if the designated period is objectively determinable and nondiscretionary at the time the payment event occurs, but only if the designated period both begins and ends within one tax year of the service provider or the designated period is not more than 90 days and the service provider does not have a right to designate the tax year of the payment. Payments made beyond a 90-day period may not be deemed compliant.[44]

Failure of a Public Company to Delay Distributions to Specified Employees for Six Months. Key employees of public companies are not permitted, under Section 409A, to terminate employment and immediately receive payment of deferred compensation. In order to avoid the ability of "specified employees" of a publically held company to time an employment termination in a manner intended to remove funds from the reach of creditors, payments must be delayed by six months following a specified employee's separation from service.[45]

Other Mistakes to Avoid

Other mistakes include:

- Failing to define "separation from service" or to use Section 409A-compliant definitions of "change of control" and "disability."
- Failure to define the meaning of employment termination for "cause."
- Failure to address the payments permissible in the event of voluntary termination for "good reason."
- Providing no schedule for payments.
- Providing for payments to be paid after the end of the short-term deferral period.
- Permitting an impermissible acceleration of payments.
- Designing a stock right plan to permit an additional deferral feature.
- Allowing employees discretion in the timing of the severance payment requirement to sign a release of claims, without attention to ensuring that the timing of the signature requirement does not inadvertently violate Section 409A.
- Providing severance payments for longer than a two-year period.
- Providing severance payments in an amount greater than two times the lesser of (1) the current Section 401(a)(17) compensation limits; or (2) annual base pay.
- Failure to combine more than one available severance pay exception from coverage under Section 409A.
- Failure to consider whether the FICA general timing rule or the special timing rules should

apply under a deferred compensation plan, and failure to properly report employment taxes, accordingly.

- Including any written guarantee, in a deferred compensation document, as to any specific tax outcome.

Spotting the Attempt to Repeal and Replace Section 409A

In 1789, Benjamin Franklin wrote to a friend that "in this world, nothing is certain except death and taxes."[46] These words still ring true. What anyone familiar with recent American history might be tempted to add is that our times are marked by notable successes in temporarily forestalling each of these. Just as advances in medical science have led to the ability to postpone death in some cases, so have the intricacies and allowances of the U.S. Tax Code led to a variety of compensation arrangements intended to promise a compensation-related benefit now, to which taxation applies only later. Both before and after the "sea change" of Section 409A's enactment,[47] deferred compensation arrangements satisfying the applicable rules have successfully postponed the recognition of income tax.

2017 House Tax Bill

At the time of this writing, developments surrounding bills relating to proposed federal tax reform are moving quickly. What is clear is that the nearly century-long allowance of deferred compensation arrangements under the U.S. Tax Code would be significantly curtailed if the terms of recent proposed legislation were enacted. The initial draft of the Tax Cuts and Jobs Act (TCJA),[48] as proposed by the U.S. House of Representatives Committee on Ways and Means on November 2, 2017 (the House Tax Bill), contained language that would drastically eliminate the opportunity for employers to reward key employees with deferred compensation arrangements. As proposed by the House, section 3801 of the TCJA would repeal Section 409A and replace it with a new Section 409B. The new Section 409B would cause any compensation deferred in connection with services performed on and after January 1, 2018 to be taxed as soon as such compensation ceases to be subject to a substantial risk of forfeiture. Because the proposed language would eliminate recognition of performance-based conditions or fixed dates as valid substantial risks of forfeiture, deferred compensation would generally be taxable upon the date of vesting, rather than on a separation from service, if later. If adjustments were not made to permit accelerated payments, the result could be that service providers would be subject to taxation even before the compensation is actually payable. These provisions would apply equally to publicly held companies, private corporations, and tax-exempt organizations. The Joint Tax Committee has estimated that the proposed change would increase revenues by $16.2 billion between 2018 and 2027.[49]

Proposal Jumps to the 2017 Senate Tax Bill

The language that would repeal Section 409A and replace it with a new Section 409B was *removed* from the final version of the House Ways & Means Committee's Tax House Bill, as issued on November 9, 2017. The Chairman's Mark of the Senate tax reform proposal issued on the same day, however, resurrected the proposals. As unveiled on November 9, 2017 by Senator Orrin Hatch, Chairman of the Senate Finance Committee, the initial Senate version of the TCJA (the Senate Tax Bill) contained the identical Section 409A repeal-and-replace provisions.

In addition to including many vested deferred compensation arrangements in income more quickly than intended under the terms of current agreements, the terms of the proposal would impact unvested amounts relating to services performed before 2018 by generally requiring that such amounts be included in taxable income as of the later of (1) the service provider's last tax year beginning before 2026 or (2) the year in which the amounts are no longer subject to a substantial risk of forfeiture. The proposed language expressly *included* stock options, and stock appreciation rights, whether settled in cash or stock. Such arrangements, even if structured to be exempt from Section 409A under the stock right safe harbor exemption discussed above, would be uniformly included in income upon vesting if the proposed provisions were enacted.

The proposed Section 409B would retain the short-term deferral exception, but with a narrower definition such that, in order to be exempt from earlier taxation, deferred compensation would be required to be paid no later than 2 $^1/_2$ months after the end of the employer's tax year. The currently permitted payment after the later date occurring 2 $^1/_2$ months after the service provider's tax year (if later) would be disregarded.

The proposal did not provide for a grandfathering period for amounts deferred, but not

yet vested, under current arrangements. This means that unvested amounts under current arrangements for which no additional service-based performance is required would become taxable upon vesting.

Subsequently, the Chairman's Mark was modified and the provision to repeal and replace Section 409A was *eliminated* from the TCJA.[50]

The Tax Reform Act of 2014

The language and structure of the proposals to restrict the deferral of compensation were in substantially the same form as the Section 409A repeal and replace provision introduced in the 2014 House Ways and Means Committee proposal known as the Tax Reform Act of 2014.[51]

Even though the Senate Tax Bill provisions limiting the options for the deferral of taxation did not survive the current legislative process, the possibility exists that its progenitor, the proposed Tax Reform Act of 2014, may continue to serve as a blueprint for future legislators in their search for broader sources of federal tax revenue. It will be necessary, therefore, for practitioners working with nonqualified deferred compensation arrangements to monitor ongoing proposed tax law and policy reforms. Employers with an interest in continuing to utilize the current deferred taxation law as a means to reward and retain key employees should contact federal representatives to let their interest be known.

Conclusion

Employers frequently enter into, and sometimes wish to modify, agreements subject to the exacting requirements of Section 409A. As a professional who assists employers in attending to compliance matters, you will provide invaluable support in avoiding the inadvertent violation of tax law if you have educated your clients as to its basic requirements. It is even more important that you, as a practitioner, can diagnose the existence of a Section 409A issue when you see (or hear about) one. While the consequences of violating Section 409A are severe, the law's provisions do permit relative flexibility in the design of customized compensation arrangements, when used properly. In light of the statute's requirements that certain payment terms be decided upon and committed to writing before an agreement is effective, focused attention, and calling upon expert assistance when warranted, is always better done sooner rather than later.

Never forget that complex Section 409A issues can arise even in otherwise seemingly routine agreements that appear, to the uninitiated, to contain only basic contract provisions. Despite the beliefs and wishes of some employers who are far removed from the practices of Enron and persistently skeptical that these complex rules really apply to straightforward payment agreements, the truth is that Section 409A applies mechanically and uniformly to all. Becoming proficient in recognizing that a "simple" contract becomes a more complicated document with tax-compliance implications when its language describes the time or form of payment of any deferred compensation will allow you and your clients to avoid honest (but consequential) errors. ■

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[45] Section 409A(2)(B)(i).

[46] 10 Writings of Benjamin Franklin 69 (A. Smyth ed. 1907), cited in *Estate of Romani*, 523 U.S. 517 (1998).

[47] Creech, "The Impact of Code Section 409A on Employment Decisions and Policies," in *New York University Review of Employee Benefits and Executive Compensation* (2008), Vol. 2, Ch. 21, page 21-2.

[48] H.R. 1, 115th Cong. (2017).

[49] House Committee on Ways and Means, Section by Section Summary of H.R. 1, available at https://waysandmeans-forms.house.gov/uploadedfiles/tax_cuts_and_jobs_act_section_by_section_hr1.pdf.

[50] See Staff of Joint Comm. on Taxation, 115th Cong., "Description of the Chairman's Modification to the Chairman's Mark of the 'Tax Cuts and Jobs Act,'" JCX-56-17, Nov. 14, 2017, page 2.

[51] H.R. 1, 113th Cong. For a detailed analysis of the Tax Reform Act of 2014, see Adams, Becker, and Liazos, "Camp Tax Reform Proposal Targets Executive Compensation," Benefits Law J., Vol. 27, No. 2 (Summer 2014).