

## OVERVIEW OF SECTION 409A AND WHY IT MATTERS

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## I. INTRODUCTION

After years of restrictions on the ability of the Treasury Department to issue guidance on nonqualified deferred compensation (see section 132 of the Revenue Act of 1978), Congress, reacting to perceived abuses of the rules governing the taxation of nonqualified deferred compensation, enacted section 409A of the Internal Revenue Code (the "Code") as part of the American Jobs Creation Act of 2004 (P.L. 108-357). Moved by the perceived abuses in Enron Corporation's deferred compensation plans (described in a report by the Staff of the Joint Committee on Taxation, JCS 3-03, February 2003), Congress also unleashed the Treasury Department's ability to regulate deferred compensation and imposed several new restrictions, many of which affect arrangements other than traditional deferred compensation programs.

This outline describes the overall structure of section 409A and the final regulations that provide detailed descriptions of the rules governing the taxation of deferred compensation, including benefits not traditionally considered deferred compensation, such as stock options and severance payments. The penalties for failure to comply with the restrictions under section 409A are detailed, as well as the restrictions themselves. This outline, originally prepared for a workshop on Section 409A presented by the Taxation Section of the Washington State Bar Association, will provide useful background for employment lawyers working on employment agreements and severance plans.

## II. PENALTIES FOR FAILING TO COMPLY WITH SECTION 409A

The major reason for deferring compensation is to defer the tax on the compensation. There is value in deferring payment of tax and the possibility that tax rates when the compensation is paid will be lower. Section 409A prevents the deferral of tax on deferred compensation that does not satisfy certain rules, but goes much further by imposing a penalty tax and interest charge on the deferred taxes.

Code section 409A provides that, if a nonqualified deferred compensation plan fails to meet the requirements of section 409A or is not operated in accordance with those requirements, all amounts deferred under the plan for the taxable year and all preceding taxable years by any participant with respect to whom the failure relates are includable in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.

In addition, any amount required to be included in income under section 409A is subject to interest and an additional income tax. Interest is imposed at the underpayment rate that applies to failure to pay income tax, plus one percent, on underpayments of tax that would have occurred if the compensation had been taxable in the taxable year in which first deferred, or, if later, the taxable year when it was not subject to a substantial risk of forfeiture. For example, the interest rate on underpayments by individuals for the third quarter of 2008 is five percent. Section 409A would impose an interest charge of six percent on tax due on deferrals made in 2008 (if fully vested).

The major hammer under section 409A is the imposition of an additional income tax on the deferred compensation equal to twenty percent of the amount of deferred compensation required to be included in gross income.

The combined effect is to eliminate the value of deferring compensation that fails to satisfy the restrictions of section 409A because it is taxed when section 409A is violated and interest plus one percent is due on the tax on the deferred compensation and an twenty percent additional penalty is imposed.

### III. WHAT IS DEFERRED COMPENSATION SUBJECT TO SECTION 409A?

Section 409A applies to "nonqualified deferred compensation plans," which are defined as any plan that provides for the deferral of compensation, with certain exceptions. The statute is intricately drafted and definitions are composed of several important components. For example, it is the deferral of compensation due to the "service provider" that is the focus of section 409A. The "service provider" can be an employee, but may also be any independent contractor, whether an individual, a corporation (including a subchapter S corporation), a partnership, a personal service corporation, and a noncorporate entity that would be a personal service corporation if it were a corporation, as long as the service provider accounts for gross income using the cash method of accounting. The "service recipient" is the person for whom the services are performed by the service recipient that give rise to a legally binding right to compensation and all persons who would be aggregated with the service recipient under the rules under Code section 414(b) and (c) that apply to controlled corporations and trades or businesses under common control. For ease of discussion, this outline refers to the service provider as an employee and the service recipient as the employer except where otherwise noted.

#### A. PLANS NOT SUBJECT TO 409A

"Nonqualified deferred compensation plan" does not include any qualified retirement plan, tax-deferred annuity, simplified employee pension, SIMPLE, or an eligible deferred compensation plan under section 457(b). Also excluded are certain welfare benefits: bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan, Archer Medical Savings Account, Health Savings Account or any other medical reimbursement arrangement that satisfies the requirements of sections 105 and 106. In addition, certain foreign plans are excluded.

The Treasury Department has so far declined to provide definitive guidance on paid time off (PTO), despite requests for guidance made before the final 409A regulations were issued. Because PTO plans can be structured to defer compensation, caution suggests that employers be conservative in permitting cash-outs of paid time off by requiring automatic cash outs when accumulations exceed a certain threshold or on termination of employment.

#### B. WHAT IS A PLAN?

"Plan" is any agreement, method or arrangement, including one that applies to only one person or individual.

It may be adopted unilaterally by the employer or may be negotiated among or agreed to by the employer and one or more employees or their representatives. An agreement may be a plan whether or not it is a plan under ERISA. The breadth of the definition allows section 409A to apply to arrangements not traditionally considered as deferred compensation, such as employment agreements that provide severance benefits and certain types of equity compensation.

In addition, to prevent abuse by adopting several plans for employees, the regulations aggregate plans of similar design, treating them as a single plan in applying the requirements of section 409A. The regulations divide plans into the following categories:

1. Elective account balance plans, i.e. plans that base benefits on contributions to an account and earnings on that account that are made at the election of the employee.
2. Nonelective account balance plans, i.e. plans to which contributions are made only by the employer.
3. Nonaccount balance plans, i.e. plans providing a benefit based on a plan formula that does not take into account the value of an account.
4. Involuntary separation pay plans.
5. Plans providing in-kind benefits and reimbursements of expenses, such as membership fees or expenses related to aircraft or vehicle usage, to the extent rights to such benefits and reimbursements do not constitute a substantial portion of either the overall compensation earned by the employee or the overall compensation due on termination of employment.
6. Split-dollar life insurance arrangements.
7. Foreign plans, which generally are plans that primarily cover nonresident aliens and under which the deferred compensation would have been treated as foreign earned income at the time of deferral.
8. Stock rights, i.e. options to buy stock other than incentive stock options or options under an employee stock purchase plan, and stock appreciation rights.
9. Any other type of deferred compensation plan not listed above.

#### C. DOES THE PLAN PROVIDE FOR DEFERRAL OF COMPENSATION?

A key issue is whether a plan provides for the deferral of compensation of the employee. The regulations state that whether a plan provides for the deferral of compensation is generally determined when the employee has a legally binding right to compensation under the plan. A plan provides for deferred compensation if the employee has a legally binding right to compensation under the plan to compensation that has not been actually or constructively

received and included in gross income, and that pursuant to the terms of the plan, is or may be payable to (or on behalf of) the employee in a later year.

An employee does not have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated by the service recipient or other person after the services creating the right to the compensation have been performed.

Compensation is not deemed to be subject to a legally binding right if facts or circumstances indicate that the discretion to reduce or eliminate the compensation is available only on a condition that is unlikely to occur or if the employee to whom the compensation will be paid has effective control of the person with the discretion to eliminate the compensation (e.g. a family member).

Factors not counted in determining if the compensation is subject to a legally binding right include substantial risks of forfeiture or other objective terms of the plan that may reduce or eliminate compensation, including investment losses.

#### D. EXCEPTIONS TO DEFERRAL OF COMPENSATION

The breadth of the definition of deferral of compensation requires the regulations to carve out a series of exceptions to allow more normal compensation arrangements to avoid becoming subject to the restrictions of 409A. For example, no deferral of compensation occurs solely because compensation is paid after the last day of the employer's taxable year in a year-end pay period pursuant to a timing arrangement under which the employer normally compensates employees for services performed during a payroll period or for non-employees, a period not longer than the payroll period.

##### 1. Short-term Deferral Exception:

A major exception in the definition of deferral of compensation is provided under the short term deferral rule. Under this rule, no deferral of compensation occurs if, absent an election to defer the payment to a later period, the plan requires payment by, and the amount is actually or constructively received by the employee by the later of (i) 2-1/2 months from the end of the employee's first taxable year in which there is no substantial risk of forfeiture, or (ii) 2-1/2 months from the end of the employer's first taxable year in which the amount is no longer subject to substantial risk of forfeiture.

This exception will not apply to any payment that will be made on or after any date that will or may occur later than the end of the 2-1/2 month period, such as termination of employment, death, disability, change in control event, specified time or scheduled of payment or unforeseeable emergency, even if the amount is actually paid during the applicable 2-1/2 month period. For example, if an employer awards a bonus under a bonus plan on November 1, 2008, subject to the requirement that the employee continue to work through December 31, 2010, and the plan provides that the bonus will be paid as a lump sum on July 1, 2011, the arrangement will give rise to deferred compensation subject to section 409A, even if the employer paid the bonus by March 15, 2011 (i.e. within the 2 1/2 month period). See Treasury regulation section 1.409A-1(b)(4)(iii) Example 5.

The short-term deferral exception may still apply if the payment is not made within the 2-1/2 month period because it was administratively impracticable and it could not be foreseen in advance that the inability to pay would have arisen, as long as payment is made as soon as it is administratively practicable. Similar relief is provided in cases where making the payment within the 2-1/2 month period would jeopardize the employer's ability to continue as a going concern or in cases where section 162(m) would deny the employer a deduction for the payment.

**Practice pointer:** a bonus program that is not intended to pay compensation subject to section 409A should state that bonuses will be paid within 2-1/2 months after the close of the taxable year. In that case, if the payment is not made within the 2-1/2 month period, the short-term deferral rule will not apply but the payment may still comply with section 409A if made in same calendar year.

However, if the employee has a right to elect a taxable year later than the year in which he obtained a legally binding right to payment, the arrangement constitutes a deferral of compensation subject to section 409A.

## 2. Severance Arrangements

Arrangements or plans that provide payments on separation from service (severance pay) are generally subject to the deferred compensation rules under section 409A. A severance pay plan may be structured to satisfy the short-term deferral exception and avoid the restrictions of section 409A in that way.

In addition, the regulations under section 409A exempt certain arrangements providing severance pay, if they meet the following requirements:

- The payment is made on account of the involuntary separation of the employee from service or pursuant to participation in a window program.
- The entire amount of payments does not exceed the lesser of 2 times the employee's annualized compensation for the calendar year before the year in which the employee terminates or 2 times the limit on annual compensation for the calendar year in which the employee terminates that can be taken into account under Code section 401(a)(17) (i.e. 2 times \$230,000 for 2008).
- The arrangement requires that all payments be made no later than the end of the second taxable year of the employee following the year in which the employee terminates service.

Reimbursement of expenses in connection with severance will not be covered by section 409A to the extent that the reimbursement arrangement covers only expenses incurred before the end of the second calendar year following the calendar year in which termination occurs (and reimbursement occurs by the end of the third calendar year), as long as the expenses must be one of the following:

- Expenses the employee could deduct under section 162 or 167 as business expenses incurred in connection with performance of services (determined without regard to the threshold for deducting such expenses)
- Reasonable outplacement expenses
- Reasonable moving expenses
- Medical expenses incurred during the period during which COBRA continuation coverage could be maintained.
- Any other types of payments that do not exceed \$15,500 in the aggregate.

### 3. Involuntary Separation from Service

Involuntary separation from service is defined as a separation from service that results from the employer's independent exercise of unilateral authority to terminate the employee's services, other than due to the employee's request, where the employee was willing and able to continue to work. The term may include failure to renew a contract after it expires, as long as the employee/service provider was willing and able to execute a new contract on terms similar to those in the old contract and to continue to provide those services. The characterization of the termination of service as voluntary or as involuntary is presumed to be correct, but the presumption may be rebutted.

The final regulations expand the term to include voluntary separation from service for good reason, where avoidance of the section 409A requirements is not a purpose of the employer's actions and where voluntary separation from service effectively is involuntary.

The conditions that constitute good reason must be defined in advance in a written agreement to require employer actions that result in material negative change to the employee in the service relationship, such as duties to be performed, conditions under which the duties are performed and the compensation to be paid for such services. Other relevant factors include the extent to which payments on separation from service for good reason remain the same as would be paid on involuntary separation from service and whether the employee is required to give the employer notice of the change in conditions of employment that would constitute good reason and gives the employer a reasonable opportunity to remedy the change.

The regulations also provide a safe harbor definition of good reason that treats an involuntary separation from service if the following requirements are met:

- The separation from service must occur no later than two years after the initial existence of one of the following conditions: material diminution of the employee's base compensation, material diminution of the employee's authority, duties or responsibilities, or material diminution in the authority, duties or responsibilities of the employee's supervisor, a material diminution in the budget over which the employee has authority, a material change in the

geographic location where the employee works, or any other action or inaction that constitutes a material breach of the employment agreement;

- The amount, time and form of payment on separation from service must be substantially the same as would be paid on involuntary termination;
- The employee must notify the employer of the existence of one of the listed conditions no later than 90 days after the initial existence of the condition and provide the employer with at least 30 days during which it may remedy the condition and not be required to pay severance.

#### 4. Equity Compensation

Grants of restricted property, including employer stock, are not subject to section 409A, as long as there is no deferral of the transfer of the property.

Nonstatutory ("nonqualified") stock options in the employer's stock are not subject to section 409A, if the option exercise price is no less than fair market value determined as of the date the option is issued. The rules for determining whose stock can be offered, how fair market value is to be determined, and what modifications and extensions may be provided without running afoul of section 409A are complex and beyond the scope of this outline. Where equity compensation is an important component of an employment agreement, it would be wise to consult with legal counsel with experience and expertise in dealing with section 409A's impact on equity compensation.

#### IV. WHAT RESTRICTIONS APPLY TO DEFERRED COMPENSATION?

##### A. RESTRICTIONS ON ELECTIONS AND TIME OF DISTRIBUTIONS

Deferred compensation to which section 409A applies must comply with the following restrictions:

- Distributions may not be made earlier than a permitted distribution event. Permitted events include separation from service, disability, a specified time or pursuant to a specified schedule set out in the plan (or deferral election) in advance, a change in ownership or control or the occurrence of an unforeseeable emergency.
- The plan may not permit acceleration of the time or schedule of any payment under the plan.
- Elections to defer compensation must be made no later than the close of the year before the year in which the compensation to be deferred is earned. The statute provides exceptions for the first year in which an employee becomes eligible to elect to defer compensation and for performance-based compensation.

- Changes in the election to delay payment or change the form of payment must not take effect for at least 12 months after the date the election is made, the election may not be made less than 12 months before the date of the first scheduled payment and, in the case of elections to have payments begin on termination of employment, at a specified time or pursuant to a specified schedule or on account of a change in ownership or control, the payment that is being deferred by the election must be deferred for at least five years from the date the payment would otherwise have been made.
- Payments to "specified employees" pursuant to separation from service must be delayed for six months after separation from service. Payment may be made earlier due to the employee's death.

A "specified employee" is an employee of an employer whose stock is publicly traded who meets the following requirement at any time during a 12-month period specified by the plan:

- An officer of the employer with annual compensation greater than \$130,000 (this figure is adjusted for cost-of-living changes and for 2008 is set at \$150,000). No more than 50 employees, or, if less, the greater of 3 employees or 10 percent of employees, may be treated as officers for this purpose.
- A 5-percent owner of the employer's shares.
- A 1-percent owner of the employer's shares with annual compensation greater than \$150,000.

The determination of who are specified employees is made annually on December 31, unless the employer designates another date. Once the determination is made, it applies effective on the first day of the fourth month after the designation date, e.g. the following April 1 for a December 31 designation date.

## B. FUNDING RESTRICTIONS

Section 409A treats assets set aside to pay deferred compensation to be treated as taxable transfers of property to the employee in the following cases:

- The assets are transferred to a trust or other arrangement located outside of the United States (except in cases where substantially all of the services that give rise to the deferred compensation are performed in the jurisdiction where the trust is located);
- Assets are held in a trust are restricted to the provision of benefits under the plan upon a change in the employer's financial health; or
- Assets are transferred to a trust or assets in a trust are restricted during a period in which the employer's qualified defined benefit plan is in at-risk funding status or the plan sponsor is a debtor in a Chapter 11 bankruptcy case

or under similar federal or state law, or during the 12-month period starting six months before the termination of the employer's qualified defined benefit plan if the defined benefit plan does not have sufficient assets to pay all benefit liabilities.

In addition to taxing the deferred compensation, interest and a 20-percent additional income tax are imposed on deferred compensation that becomes taxable for violation of the funding rules.

#### C. PERMITTED PAYMENT EVENTS

Payment of deferred compensation may be made only after a permissible distribution event specified in the plan or the initial deferral election:

- Termination of employment ("specified employees" must wait at least six months after termination of employment)
- Disability
- Death
- A date or event specified and objectively determinable at the time the compensation was deferred
- Certain changes in control
- Unforeseeable emergency

Plans may designate a different time and form of payment for each different type of payment event.

Payments are treated as made on a designated payment date if made on that date or on any late date within the employee's same taxable year or, if later by the 15th day of the third calendar month after the date specified by the plan.

#### D. INITIAL ELECTIONS

The general rule is that initial deferral elections must be made before the start of the employee's taxable year in which the services will be performed that give rise to the compensation being deferred. The election may cover the time or form of payment or both. The plan may effectively make the election for the employee (as in the case of deferred compensation plans providing certain pension benefits) or may permit the employee to make the election. Plans may permit elections to be made and revoked, as long as the last election made becomes irrevocable by the close of the year before the year the services will be performed.

The regulations provide special rules for different types of elections:

- Elections to defer amounts that would be exempt from section 409A under the short-term deferral rules can be made if they comply with the rules for

subsequent changes in elections, namely, that the election must be made at least 12 months before the scheduled payment date for the amount to be deferred, the election does not take effect for at least 12 months after it is made and the payment date must be deferred by at least five years. The five-year deferral is waived for payments to be made on account of a change in control event.

- An election can be made after an employee obtains a legally binding right to the payment, as long as the employee's right to the payment will not vest until the employee has rendered services for at least 12 months after the employee obtains a legally binding right to the payment, the payment amount is not yet vested (i.e. is still subject to a substantial risk of forfeiture) at the time of the election, the election is made on or before the 30th day after the employee obtains a legally binding right to the payment, and the election is made at least 12 months before the earliest date on which the right to the payment vests (early vesting on account of the employee's death or disability or a change in control event is ignored for this purpose).
- If the employer's taxable year is different from the employee's (i.e. is a fiscal year) and the plan determines compensation based on the employer's fiscal year, then the employee's election may be made by the close of the employer's taxable year before the employer's fiscal year in which the employee will perform services that give rise to the compensation being deferred.
- Elections can be made within 30 days after the date the employee becomes eligible to participate in a plan with respect to compensation paid for services to be performed after the election. For compensation earned based on a specified performance period (e.g. an annual bonus), the amount deemed to be earned after the election is made is based on the amount earned for the entire performance period multiplied by the number of days after the election divided by the total number of days in the performance period. When an employee first becomes eligible to participate in a plan is based, in part, on whether the employee is already a participant in a plan of the same type.
- Special rules apply to elections to defer performance-based compensation (e.g. deferrals of incentive pay under annual or multiple-year incentive periods). Elections can be made at any time on or before the date that is six months before the end of the performance period during which the employee earns the compensation, as long as, when the election is made, the compensation is not substantially certain to be paid (if the amount is specified or can be calculated) or, if the amount will not be calculable until a later date, e.g. the end of the performance period, when the amount can be calculated and is substantially certain to be paid.
- Additional special rules apply to initial elections made with respect to nonqualified deferred compensation plans linked to qualified retirement plans, changes in elections under a cafeteria plan, deferrals of severance pay,

deferrals of commission compensation, compensation paid for payroll periods that span the end and start of two adjoining taxable years, elections to annualize recurring part-year compensation (e.g. teacher pay) and deferrals made by employees returning from military service with rights protected under federal law.

## E. CHANGES TO ELECTIONS

Deferral elections, once made, may be changed only if the plan permits it and if the change in the election satisfies rules in section 409A and the regulations. Such subsequent deferral elections are deemed made only when they become irrevocable under the terms of the plan.

A deferral election may be changed only if it meets the following requirements:

- The plan must require that the election not take effect until at least 12 months after the date on which the election is made.
- The plan must require that the payment to which the election applies must be deferred for at least 5 years from the date the amount was originally scheduled to be paid, except for payments on account of:
  - Disability
  - Death
  - Unforeseeable emergency
- The plan must require that any election related to a payment that is to be made at a specified time or pursuant to a fixed schedule be made no less than 12 months before the date the payment is to be paid.

A payment for purposes of the subsequent deferral rules is generally a separately identified amount to which the employee is entitled to payment at a determinable date, e.g. 10 percent of an account balance.

### 1. Annuity Payments

Entitlement to an annuity for life is treated as a single payment. Thus, elections to delay the start of annuity payments or to change the form of annuity must be made at least 12 months before the scheduled start of the annuity and must defer the payment for at least 5 years from the originally scheduled starting date.

On the other hand, the regulations treat a change in designated beneficiary before any annuity payment has been made as not a change in the time or form of payment that would be subject to the rules restricting changes in payment elections.

Similarly, a change in the form of a payment before any annuity payment has been made from one life annuity to another type of life annuity with the same scheduled date for the first payment

is not treated as a change in time or form of payment as long as the annuities are actuarially equivalent.

## 2. Installment Payments

Entitlement to a series of installment payments that are not a life annuity is treated as a single payment, unless the plan provides that at all times the right to the series of installments is to be treated as a right to a series of separate payments.

Changing the period over which installments will be paid or the date that installment payments begin will be treated as a change in form or time of payment that is subject to the rules for changing elections.

Plans may provide that payment of the balance of an employee's account under the plan in a single sum once the account falls below a certain threshold is permitted without violating the rules on changing payment elections or accelerating payments.

## 3. Exceptions from Rules for Election Changes

The rules exempt the following types of changes from the rules governing changes in payment elections:

- Changes in the beneficiary who receives benefits on death of the employee.
- Changes in payments may be made by a spouse or former spouse pursuant to a domestic relations order.
- Delay in payment for any of the following reasons:
  - To avoid loss of deduction under section 162(m) (which generally limits deductions of compensation of certain executives of publicly held corporations to \$1,000,000), as long as payment is made during the employee's first taxable year in which the employer reasonably anticipates that deduction of the payment will not be barred by section 162(m).
  - To avoid violation of Federal securities laws or other applicable law, as long as payment is made at the earliest date that the employer reasonably anticipates will not cause such a violation.
- Changes in elections to comply with laws protecting employees called to military service.

## F. ACCELERATION OF PAYMENT

Nonqualified deferred compensation plans may not permit acceleration of the time or schedule of any payment or amount scheduled to be paid under the plan's terms. Nor may an accelerated

payment be made, whether or not the plan provides for it. Plans may permit payment on an accelerated payment if another intervening payment event (e.g. death) occurs.

A change in the election of the time and form of payment that satisfies the rules for such election changes will not violate the non-acceleration rule, even if the new schedule accelerates some payments.

Plans may permit acceleration of payment in the following cases:

- A plan may provide for acceleration of the time or schedule of payment to someone other than the employee to the extent necessary to satisfy a domestic relations order, e.g. a court order dividing benefits between the employee and a former spouse.
- A plan may provide for acceleration of time of payment to the extent necessary for an federal employee in the executive branch to comply with an ethics agreement with the federal government. Similarly plans may permit acceleration to the extent reasonably necessary to avoid violation of applicable federal, state, local or foreign ethics or conflicts of interest laws.
- Certain nonqualified plans of tax-exempt employers may permit acceleration of time or schedule of payment to pay federal, state, local or foreign income tax withholding due when benefits under the plan vest.
- A plan may require or provide the employer with discretion to require mandatory lump sum payment of amounts that do not defer the limit on elective deferrals under 401(k) plans (\$15,500 in 2008), if the payment liquidates the employee's entire interest in the plan.
- A plan may provide for acceleration of the time or schedule of payment as required to pay taxes due under FICA or the Railroad Retirement Act on compensation deferred under the plan as well as income tax withholding required on the amount paid out to pay FICA or Railroad Retirement Act taxes.
- A plan may also provide for acceleration of the time or schedule of payment at any time the plan fails to satisfy the requirements of section 409A and its underlying regulations.
- A plan may provide for acceleration of time and form of payment pursuant to a termination or liquidation of a plan if the following requirements are met:
  - The plan is terminated and liquidated within 12 months of a corporate dissolution taxed under Section 331 of the Code or with the approval of a bankruptcy court, as long as amounts deferred under the plan are included in employee income in the latest of the calendar year in which the plan termination and liquidation occurs, the first calendar

year in which the deferred amount is no longer subject to a substantial risk of forfeiture (i.e. becomes fully vested), or the first calendar year in which payment is administratively practicable.

- The plan is terminated and liquidated pursuant to irrevocable action taken by the employer during 30 days before or 12 months following a change in control event, as long as all amounts treated as deferred under a single plan are terminated and liquidated for each affected participant.
- The plan is terminated and liquidated as long as all other arrangements aggregated with the plan are also terminated and liquidated. The termination and liquidation may not occur close to a downturn in the employer's financial health. No payments in liquidation of the plan are made within 12 months of the date the employer takes irrevocable action to terminate and liquidate the plan (other than payments that would normally be payable even if the plan was not terminated). All payments are made within 24 months of the date the employer takes all necessary action to terminate and liquidate the plan. The employer does not adopt a new plan of the same type for at least 3 years after the date the employer takes all required action to irrevocably terminate and liquidate the plan.
- A plan may permit acceleration of the time and form of payment to reflect payment of state, local, or foreign taxes arising from participation in the plan.
- A plan may permit cancellation of an employee's deferral election due to the employee's disability, if the cancellation occurs by the later of the end of the employee's taxable year in which the employee incurs a disability or the 15th day of the third month after the disability is incurred.
- A plan may provide for acceleration of time or schedule of a payment, or a payment may be made to satisfy a debt of the employee to the employer, if the debt is incurred in the normal course of employment, the entire amount of the reduction in any year does not exceed \$5,000 and the reduction is made at the same time and in the same amount as would otherwise have been due.
- A plan may provide for acceleration of time and schedule of payment or a payment may be made under a plan where the payments occur as a part of a settlement between the employer and the employee of an arm's length bona fide dispute over the employee's right to payment. This exception to the rules prohibiting acceleration of payments is presumed not to apply unless there is a substantial payment in the amount paid to the employee (25 percent reduction of the present

value of the payment is the minimal amount generally required to be substantial). This exception does not apply if the payment is made around the time of a downturn in the employee's financial health.

#### G. DEFINITION OF SUBSTANTIAL RISK OF FORFEITURE

A key issue is when amounts are subject to a substantial risk of forfeiture, i.e. not vested. The preamble to the regulations make clear that the definition of a substantial risk of forfeiture is narrower the rules under section 83 of the Code. Section 83 sets out rules for the taxation of transfers of property from an employer (or service recipient) to an employee (or service provider), including rules that defer taxation on transfers of property until the rights to the property are no longer subject to a substantial risk of forfeiture (i.e. are vested).

In general, amounts are subject to a substantial risk of forfeiture if the entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to the purpose of the compensation; and the possibility of forfeiture is substantial.

A condition related to the purpose of the compensation must relate to the employee's performance for the employee or the employer's business activities or organizational goals, e.g. achieving a prescribed level of earnings.

Involuntary separation from service can be a substantial risk of forfeiture with respect to a payment (e.g. severance pay) if the right to payment is conditioned on involuntary termination without cause and the possibility of forfeiture is substantial (e.g. because the severance pay will never be paid if the employee never separates from service involuntarily).

Merely refraining from performing services (as in a noncompete agreement) is not a substantial risk of forfeiture.

Adding a risk of forfeiture after the right to payment arises or extending the period during which the right to payment is subject to a risk of forfeiture is disregarded.

#### V. EFFECTIVE DATE OF SECTION 409A; GRANDFATHERED PLANS

##### A. EFFECTIVE DATE

Section 409A generally applies to amounts deferred in taxable years beginning after December 31, 2004. Amounts deferred before January 1, 2005 are also subject to section 409A if the plan under which the amount was deferred is materially modified after October 3, 2004; or the right to the amount was not earned and vested before January 1, 2005.

Amounts deferred before January 1, 2005 pursuant to a plan that was in effect on October 3, 2004 are not subject to section 409A if the amount was earned and vested before January 1, 2005 and the plan is not materially modified after October 3, 2004. Such amounts are sometimes referred to as "grandfathered" amounts.

Special effective dates apply to amounts deferred under a plan pursuant to a bona fide collective bargaining agreement in place on October 3, 2004.

The amount treated as deferred before January 1, 2005 is determined as follows:

- If the plan is a nonaccount balance plan (e.g. a supplemental pension plan), the amount treated as deferred before January 1 is the present value of the amount the employee would have been entitled to under the plan if the employee voluntarily terminated employment without cause on December 31, 2004.
- If the plan is an account plan (e.g. a supplement to a 401(k) plan), the amount deferred is the portion of the account balance that is earned and vested on December 31, 2004, plus future contributions to the account to the extent the right to the contributions was earned and vested as of December 31, 2004.
- Earnings on amounts deferred before January 1, 2005 are generally treated in the same way as the principal amount of pre-2005 deferrals.

#### B. LOSS OF GRANDFATHERED STATUS

Material modifications to a plan will result in subjecting amounts deferred before 2005 to section 409A. A modification to a plan is material if a benefit or right existing as of October 3, 2004 is materially enhanced or a new material benefit or right is added and the material enhancement or addition affects amounts earned and vested before January 1, 2005.

The modification may result because the employer amends the plan or exercises discretion under the terms of the plan. An example would be to add a provision to permit payment of amounts deferred before 2005 on the employee's request subject to a forfeiture of 20 percent of the amount paid (sometimes referred to as a "haircut"). Similarly, accelerating vesting of a benefit under the plan to a date before 2005 would be a material modification.

The regulations also permit the following actions without being deemed to have materially modified the plan in such a way as to subject deferrals under the plan before 2005 to section 409A:

- The employer's exercise of discretion provided under the terms of the plan in effect as of October 3, 2004.
- The amendment of a plan to bring it into compliance with section 409A, except to the extent the amendment itself materially enhances an existing benefit or right or adds a new material benefit or right - even if permitted under section 409A. For example, adding a right to payment upon an unforeseeable emergency would be a material modification.
- Reducing an existing benefit, e.g. removing a "haircut" provision.

- Compliance with the requirements of a domestic relations order or amending the plan to require such compliance is not a material modification.
- Ceasing deferrals under a plan or terminating a plan pursuant to the plan's provisions is not a material modification.
- Certain changes in the measure of notional rate of return on deferred amounts (in account balance plans).
- Modification of stock options and stock appreciation rights to comply with section 409A.
- Rescission of modifications to a plan that would inadvertently result in a material modification if the rescission occurs before the earlier of a date before the right is exercised or the last day of the taxable year in which the plan change occurred.

## VI. WRITTEN DOCUMENTATION REQUIRED

The preamble to the final section 409A regulations states that plans must be amended effective January 1, 2008, to bring deferred compensation plans into compliance with section 409A on or before December 31, 2007, with respect to deferred compensation that has not been paid by January 1, 2008.

The Internal Revenue Service granted transition relief in Notice 2007-86, 2007-46 I.R.B. 990, to permit deferred compensation plans to be amended as late as December 31, 2008, with the amendments to be effective on January 1, 2009.

Amendments are not required to reflect any amendments made or actions taken under transition rules to the extent the amendments or actions do not affect the plan's compliance with section 409A for periods on or before January 1, 2009.

For example, if a plan includes a provision permitting employees to withdraw deferred compensation at any time, subject to forfeiting 20 percent of the amount to be withdrawn, the provision need not be removed retroactively for periods before January 1, 2009, if the plan has been operated in compliance with applicable transition guidance. This would mean that no amounts subject to section 409A had been paid under the provision.

The plan need not be amended for amounts paid on or before December 31, 2008, in compliance with transition guidance. But the employer must be able to demonstrate that the plan was operated in compliance with transition guidance.

The IRS has been clear that catchall clauses that merely recite that the plan will be operated in compliance with section 409A, with no change in applicable substantive provisions, will not be deemed a sufficient amendment to comply with section 409A's rules.

Care needs to be taken when renegotiating employment agreements that provide deferred compensation, including severance pay that is subject to section 409A. The IRS has stated that if

an employment agreement is either extended or renegotiated, granting a right to deferred compensation (which may include certain types of severance pay) will not be viewed as a substitution for existing rights to deferred compensation under the original agreement so long as the employee would have no rights to the deferred compensation after the original agreement expired. For example, if an executive is entitled to severance compensation that exceeds the amount that the two-times pay rule would exempt from section 409A, some part of the severance compensation would be subject to section 409A. If the executive has no right to severance pay when the agreement expires at the end of its normal term, then the parties may renegotiate or extend the agreement to provide severance pay under a new or revised agreement without running afoul of section 409A. If, on the other hand, the executive was entitled to severance pay after the end of the normal term of the employment agreement, then renegotiating the agreement to extend the date on which severance is paid until a date after the original payment date would be treated as a change in the date on which severance was payable under the original agreement. Failure to make such a change in a way that complies with section 409A could result in a violation of section 409A that would result in tax penalties.