Client Alert

Executive Compensation & Benefits

Overview: Proposed Section 409A Regulations Provide Increased Flexibility For Nonqualified Deferred Compensation Plans

October 18, 2005

On September 29, 2005, the Internal Revenue Service (IRS) publicly issued its long-awaited proposed regulations under Section 409A of the Internal Revenue Code (Code). Section 409A, which was enacted as part of the American Jobs Creation Act of 2004, established new procedural and substantive requirements for nonqualified deferred compensation plans and arrangements. The proposed regulations incorporate most of the prior guidance provided in IRS Notice 2005-1, which was issued on December 20, 2004, but with certain clarifications and modifications in response to public comments. In addition, the proposed regulations provide initial guidance on several subjects that were not addressed in Notice 2005-1; including, for example, rules respecting initial deferral elections, time and form of payment and subsequent elections to change time and form of payment. Generally, the proposed regulations provide service recipients (i.e., plan sponsors) with a welcomed degree of flexibility in designing deferred compensation plans and arrangements that will comply with Section 409A; although several traps for the unwary do remain.

This Client Alert provides an overview of key provisions of the proposed regulations and is the one of a series of Client Alerts prepared by Pillsbury Winthrop Shaw Pittman LLP that explain the substantive provisions of the proposed regulations and identify issues raised by the proposed regulations. Links are provided at the end of this Alert to our other Client Alerts on the Section 409A proposed regulations, including Alerts dealing with the effective dates and transition rules, stock compensation provisions of the proposed regulations and the application of Section 409A to foreign benefit provisions.

Effective Date of Proposed Regulation and Good Faith Compliance

The proposed regulations are not effective until January 1, 2007, although compliance with the proposed regulations prior to such time will be deemed to be good faith compliance with Section 409A. Although the proposed regulations extend through the end of 2006 much of the transition relief provided under Notice 2005-1, the regulations do not extend the deadline for opting out of the requirements of Section 409A.

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- Planning Note: Thus, plan terminations or elections to cancel deferrals and opt of plan participation must still be completed, and accounts must be distributed, before the end of 2005 in order to avoid the need to comply with Section 409A going forward.

A more detailed discussion of the effective date, good faith compliance period and transition rules for the proposed regulations is contained in our September 29, 2005 Client Alert entitled "*Nonqualified Deferred Compensation – IRS Issues New Proposed Regulation Under Section 409A of the Internal Revenue Code*", which can be accessed by clicking on the link at the end of this Alert.

Nonqualified Deferred Compensation Subject to Section 409A

The proposed regulations confirm that deferred compensation subject to Section 409A generally includes a legally binding right acquired during a taxable year to compensation that is payable in a later year.

Negative Discretion. Consistent with Notice 2005-1, the proposed regulations provide that, for purposes of determining whether there has been a deferral of compensation, no legally binding right to compensation exists if the compensation may be unilaterally reduced or eliminated after the services creating the right have been performed. The proposed regulations clarify, however, that negative discretion will *not* be recognized if it lacks substantive significance or is available or exercisable only upon a condition. Negative discretion will also be ignored where the service provider has certain influence over the person who exercises the discretion.

Short-Term Deferrals. The proposed regulations incorporate the exception from Section 409A coverage for short-term deferrals, *i.e.*, deferrals no longer than 2½ months after the later of the end of the service provider's or service recipient's taxable year, but provide increased flexibility and some protection from inadvertent violations by permitting extensions of the 2½-month short-term deferral period where it is either administratively impracticable to make the payment by the 2½-month deadline or where making the payment by the deadline would jeopardize the solvency of the service recipient. Extension of the 2½-month short-term deferral period is not available, however, if the circumstances causing the payment delay were foreseeable at the time the legally binding right to the compensation arose or the delay is caused by the service provider or someone controlled by the service provider.

- Planning Note: Although there is no requirement that a plan document specify in writing that payments must be made by the short-term deferral deadline in order to avoid application of Section 409A (so long as the payment is actually made by the deadline), plan sponsors should consider including a date or year of payment in the written plan document, even if it is intended that the payment will be made within the short-term deferral period. For example, if the plan document does not specify that a particular payment must be made within the 2½-month short-term deferral period, failure to actually make the payment by the deadline will result in the payment becoming subject to Section 409A, with an automatic violation of Section 409A due to a failure to specify a payment date. In contrast, if the plan provides that payment must be made by the end of the 2½-month short-term deferral period, and the payment subsequently becomes subject to Section 409A due to a failure to make the payment within the short-term deferral period, then the payment will comply with Section 409A so long as it is made by the end of the calendar year within which the short-term deferral period ends.

Equity Compensation. In response to comments to Notice 2005-1, the proposed regulations conform the treatment of stock appreciation rights (SARs) to that of nonqualified stock options and extend the exception for SARs to grants by private companies and grants that are settled in cash. Also, the proposed regulations provide detailed rules regarding, among other things, the conditions for the exception for stock options and SARs, including a requirement for the reasonable valuation of service recipient stock for purposes of determining fair market value and the circumstances under which the modification of a stock option or SAR will be deemed to result in a new grant. A more detailed discussion of the equity compensation issues addressed in the proposed regulations is contained in our Client Alert entitled "*Stock Compensation Provisions in Proposed Regulations Under Section 409A of the Internal Revenue Code*", which can be accessed by clicking on the link at the end of this Alert.

Severance Pay. The proposed regulations confirm that severance plans, which are referred to as "separation pay arrangements" in the proposed regulations, are subject to Section 409A, whether or not the plans cover any key employees or provide for payments only upon an involuntary separation from service. The proposed regulations, however, specifically exclude from Section 409A coverage arrangements that provide for separation pay upon either an actual involuntary separation from service or pursuant to a voluntary window program if either of the following conditions are met:

- The arrangement is contained in a collective bargaining agreement and was the subject of arm's-length labor negotiations, or
- The entire amount of payment under the arrangement does not exceed two times the lesser of the service provider's prior year's annual compensation or the limit on annual compensation that may be taken into account for qualified plan purposes under IRC Section 401(a)(17) for the prior year (*i.e.*, $210,000 for 2005, increasing to $220,000 for 2006) <u>and</u> all payments are made not later than December 31st of the second calendar year following the year in which the service provider separates from service. (*This exclusion effectively keeps most broad-based severance plans outside the reach of Section 409A*).

The proposed regulations also exclude from Section 409A coverage certain reimbursement arrangements related to a termination of service, *e.g.*, reasonable outplacement and moving expenses, continued medical coverage, *etc.*, but only to the extent that the arrangement covers expenses incurred and reimbursed before the end of the second calendar year following the calendar year in which termination occurs. Reimbursement of de minimis expenses, *i.e.*, not exceeding $5,000 is also exempted.

- Caution: The exclusions for separation pay do not apply to the extent that the separation pay substitutes for or replaces amounts that would otherwise be subject to Section 409A. For example, a right to separation pay obtained in exchange for the relinquishment of deferred compensation rights will not be excluded from Section 409A coverage to the extent that the rights relinquished were subject to Section 409A.

- Planning Note: So long as separation payment will be made only upon an involuntary separation from service, the payment right will be viewed as a nonvested right. Accordingly, where the separation pay is not excluded from Section 409A coverage, *e.g.,* because it provides for payments greater than two times annual compensation, the arrangement can still be structured to avoid application of Section 409A by meeting requirements for short-term deferral, *i.e.*, completing all payments by end of the short-term deferral period.

Initial Deferral Election Rules

General Rule. Section 409A and the proposed regulations provide generally that a service provider must make a deferral election, including an election as to the time and form of payment, in the taxable year before the year in which the services giving rise to the compensation are performed.

Evergreen Elections. The regulations confirm that an evergreen election, *i.e.*, a deferral election that remains in place for all subsequent years unless and until the service provider elects otherwise, can be structured to satisfy the initial deferral election requirements, provided that the election becomes irrevocable with respect to a subsequent year not later than the election deadline for such subsequent year.

Nonelective Arrangements. The regulations clarify that, in order to avoid application of the initial deferral election rules for nonelective arrangements, a plan may not provide a service provider or service recipient with any discretion as to the amount of the deferral and the time and form of payment, but must set the amount of the deferral and the time and form of payment not later than the time the service provider would have been required to make an irrevocable deferral election had the arrangement been an elective arrangement (*e.g.*, prior to the end of the taxable year preceding the service year).

First-Year of Eligibility. Section 409A and the proposed regulations permit initial deferral elections to be made within 30 days after a service provider first becomes eligible to participate in the plan, but only with respect to compensation paid for services performed subsequent to the election. The proposed regulations clarify that, for compensation based on a specified performance period (for example, an annual bonus), where a deferral is made in the first year of eligibility but after the beginning of the service period, the election is deemed to apply to compensation paid for service performed subsequent to the election if the election applies only to a prorated portion of the total compensation, based on the percentage of the service period remaining after the election is made. Also, the proposed regulations confirm that the plan aggregation rules apply in determining whether a service provider is newly eligible for participation.

- Example: An employee who already is eligible for a broad-based salary deferral account balance plan and who subsequently becomes eligible for a management account-balance plan due to a mid-year promotion will *not* be permitted to utilize the first-year-of-eligibility rule to make a mid-year deferral under the management plan because the broad-based plan and management plan must be aggregated for this purpose.

Mid-Year Grants of Certain Forfeitable Rights. To accommodate service recipients that might make mid-year "ad hoc" grants of certain forfeitable rights (*e.g.,* restricted stock units) that were unforeseeable prior to the start of the year, the proposed regulations provide that where the mid-year grant is subject to a forfeiture condition requiring the continued performance of at least 12 months of services, the initial deferral election may be made not later than 30 days after the date of grant, provided that the election is made at least 12 months prior to the end of the service period.

Performance-Based Compensation. With respect to the deferral of "performance-based compensation" that is based on a performance period of at least 12 months, Section 409A and the regulations permit the initial deferral election to be made not later than six months prior to the end of the applicable performance cycle, but only if at the time the deferral election is made, either the amount of the compensation is not readily ascertainable or the right to receive the compensation is not substantially certain. The proposed regulations confirm that, for this purpose, the performance criteria for performance-based compensation may be established up to 90 days after the commencement of the service period, provided that the outcome is not substantially certain at the time the criteria are established, and may include subjective criteria if certain conditions are met. Also, unlike the position taken in Notice 2005-1, the proposed regulations permit performance-based compensation to be based solely an increase in value of the service recipient or the service recipient's stock.

Commissions. The proposed regulations treat a service provider as having performed the services that give rise to commissions during the service provider's taxable year in which the customer pays for the goods or services that generated the commissions. Thus, the initial deferral election with respect to such commissions may be made not later than December 31 of the calendar year preceding the year in which the customer renders payment.

Separation Pay Arrangements. Where the separation pay arrangement is the result of an arm's-length agreement negotiated at the time of an involuntary separation from service, the proposed regulations provide that the initial election as to the time and form of payment may be made on or before the date the service provider obtains a legally binding right to payment.

Time and Form of Payment

General Rule. The proposed regulations incorporate the Code Section 409A requirement that payments be made only at a fixed date or upon a fixed schedule, or upon any of five events: a separation from service, death, disability, a change in ownership or effective control of a corporation or an unforeseeable emergency. Where the payment is made upon the occurrence of one of the five events, the regulations require the plan to designate an objectively determinable date or year following the event upon which the payment is to be made, *e.g., within 90 days after* a change in control, or *during the first calendar year following* a separation from service.

Multiple Payment Events. The proposed regulations confirm that a plan may provide that payments be made upon the earlier of, or later of, two or more designated events or times, so long as each such event or time is otherwise permissible. Also, the proposed regulations provide that a different form of payment may be applied to each potential payment event.

Time Limit For Making Payments. Recognizing that it is not always administratively feasible to make a payment on the exact date designated in the plan, the proposed regulations provide that a payment is treated as made on the designated payment date if *either* the payment is actually made on such date *or* if it is made on or before the later of the end of the calendar year that includes the designated payment date or the 15th day of the third calendar month after the designated payment date. Also, if calculation of the payment amount is not administratively practicable due to event beyond the control of the service provider (or the service provider's estate), or if the service recipient lacks sufficient funds to make the payment on the designated date without jeopardizing its financial solvency, the payment will be treated as made on the designated date if it is made at any time during the first calendar year in which the payment becomes administratively practicable, or in which the service recipient has sufficient funds to make the payment without jeopardizing its financial solvency.

- Note: There seems to be an inconsistency between the rule stated in the actual text of the proposed regulations, which is described above, and the rule described in the preamble to the proposed regulations, which provides that a payment is timely if it is made by the later of the first date after the designated payment date that it is administratively feasible to make the payment or the end of the calendar year containing the designated date. We assume that the rule described in the actual text of the proposed regulation will control.

Specified Time or Fixed Schedule. The proposed regulations permit a plan to specify simply the calendar year or years in which payments are scheduled to be made, without specifying the particular date within such year on which the payment will be made.

- Planning Note: If a plan simply designates a calendar year, instead of a specific date, for payments to be made or commence, the first payment will be deemed to be scheduled for January 1 of such year for purposes of the subsequent election rules described below, regardless of the date the payment will actually be made.

Separation From Service. The proposed regulations provide detailed guidance regarding the circumstances under which service providers, including employees and independent contractors, will be treated as separated from service for purposes of Section 409A. The proposed regulations also include an "anti-abuse rule" whereby an employee who actually or purportedly continues as an employee, but is not intended to provide more than insignificant services to the employer, will be treated as having incurred a separation from service. A converse anti-abuse rule treats a former employee who continues to provide substantial services to his employer in a capacity other than as an employee (*e.g.*, as a consultant or independent contractor) as not having incurred a separation from service. Also, the preamble to the proposed regulations clarifies that the "same desk rule" applicable to IRC Section 401(k) plans does not apply to Section 409A.

- Example: A service provider who continues in the same job with a successor employer after the sale to the successor employer of substantially all of the assets of the original employer *will* be deemed to have incurred a separation from service from the original employer for purposes of Section 409A.

Six-Month Payment Delay For Key Employees. The proposed regulations clarify that the identification of key employees for purposes of the rule requiring a six-month delay in payments to a key employee of a public company following a separation from service is based upon the 12-month period ending on the identification date chosen by the service recipient, so that persons who meet the requirements of a "key employee" during such 12-month period will be considered to be key employees for purposes of the plan for the 12-month period beginning on the first day of the 4th month following the end of the 12-month period. The default identification date is December 31.

- Planning Note: A service recipient may chose an identification date other than December 31 so long as the same identification date is used for all its plans, and any change to the identification date may not be effective for a period of at least 12 months.
- Planning Note: A service recipient may draft its nonqualified deferred compensation plan to provide for a six month delay for all participants in order to avoid an annual determination of who would be a key employee.
- Transition Rule: The proposed regulations include a transition rule whereby any designation of an identification date made on or before December 31, 2006 may be applied to any separation from service occurring on or after January 1, 2005.

The plan document must describe the manner in which the six-month payment delay for key employees will be implemented. For example, the plan may provide that any payments to which a key employee would otherwise be entitled during the first six months following the separation from service are accumulated and paid on the first day of the seventh month with the seventh month's payment. Alternatively, the plan may provide that each installment payment to key employees is delayed for a period of six months following separation from service.

- Planning Note: A plan of a publicly traded company may be amended to change the manner in which the delay may be implemented, but any such amendment may not be effective for at least 12 months. Private companies that become publicly traded companies are permitted to amend their plans immediately upon becoming a publicly traded company.

Disability. The proposed regulations permit a plan to provide that a service provider will be deemed disabled for purposes of Section 409A if the Social Security Administration determines that the service provider is totally disabled.

Change in Effective Ownership or Control of a Corporation. The rules for determining whether there has been a change in effective ownership or control of a corporation contained in Notice 2005-1 are incorporated in the proposed regulations substantially unchanged.

- Application of Change in Control Rules to Partnerships. Although neither the statute nor legislative history permits a distribution upon a change in control of an entity other than a corporation, the IRS indicated that they plan to use their authority under Section 409A(a)(3), which permits the Treasury Secretary to provide exceptions to Section 409A's anti-acceleration rules, to issue subsequent regulations that will allow acceleration of payments upon a change in the ownership of a partnership or in the ownership of a substantial portion of the assets of a partnership. In the meantime, the proposed regulations permit the rules regarding permissible distributions upon a change in control of a corporation to be applied by analogy to changes in control of a partnership.

Unforeseeable Emergency. The proposed regulations clarify the definition of "unforeseeable emergency" and permit a plan to provide that a deferral election terminates if a service provider obtains a payment upon an unforeseeable emergency, or if such termination is required in order for the service provider to be able to obtain a hardship distribution under a 401(k) plan.

- Planning Note: In such case, the deferral election must be terminated, not merely suspended. Thus, a subsequent deferral election made after such termination must satisfy the requirements of an initial deferral election.

Subsequent Changes to Time and Form of Payment

General Rule. Section 409A and the proposed regulations provide that if a plan permits subsequent elections to delay a payment or change the form of a payment, the plan must require that the following conditions be met with respect to any such subsequent election:

- The election must not take effect until at least 12 months after the date of the election;
- In the case of an election related to a payment other than on account of death, disability or unforeseeable emergency, the first payment covered by the election must be deferred for a period of not less than five years from the date the payment was initially scheduled to be made; and
- In the case of an election related to a specified time or fixed schedule, the election must be made at least 12 months prior to the specified time or the date of the first scheduled payment.

Definition of Payment. The proposed regulations provide generally that each separately identified amount to which a service provider is entitled to payment under a plan on a determinable date is a separate payment. The proposed regulations, however, treat life annuities and installment payments as a single payment, payable on the date of the first scheduled payment, for purposes of the subsequent deferral rules. A plan may, however, provide that installment payments (but not life annuities) be treated as a series of separate payments, provided that such treatment is applied consistently for purposes of the subsequent deferral and anti-accelerations rules.

- Example: If a series of 10-year installment payments is treated as a single payment and the first installment is scheduled to be paid on January 1, 2010, then, consistent with the five-year additional deferral rule, a service provider may change the time and form of payment to a lump sum payable on January 1, 2015 (five years after the date of the first scheduled installment payment). Provided that the other conditions related to a change in the time and form of payment are met, the change will not be treated as an impermissible acceleration, even though the change resulted in a more rapid payment of the service provider's total account.

In contrast, if the plan provided that installment payments be treated as a series of separate payments, then the service provider could not change the time and form of payment to a lump sum payable on January 1, 2015 because the installments scheduled for 2011 through 2019 would not have been deferred for five additional years. Instead, in this case, the service provider may change the form of payment to a lump sum only if the lump sum payment is scheduled to be made on or after January 1, 2024 (five years after the date of the last scheduled installment payment).

- Planning Note: The proposed regulations include a transition rule whereby a plan adopted and effective before December 31, 2006 that does not designate whether installments will be treated as a single payment or a series of payments will be treated as having made such designation as of the later of the plan's adoption or effective date, provided that the designation is made in writing before December 31, 2006. Such action is needed, however, only if the service recipient wishes to treat the installments as a series of separate payments, since the default is to treat the installments as a single payment.

Application to Multiple Payment Events. The proposed regulations provide that, if a plan permits payments on the earlier of, or later of, two or more designated events or times, the subsequent election rules apply separately to each such event or time.

- Example: Assume a service provider initially elected to receive either an annuity at age 65 or, if earlier, a lump sum at separation from service. If the plan provides for subsequent changes to the time and form of payment, the service provider may elect to delay the annuity payment to age 70 and still be entitled to a lump sum on separation from service, if earlier.

Other Provisions Pertaining to Payments

Permitted Payment Delays by Service Recipient. The proposed regulations permit a plan to provide that a service recipient will delay payment of deferred amounts where (1) the service recipient's tax deduction for the payment would be limited or eliminated by the application of IRC Section162(m), (2) the payment would violate applicable securities laws, or (3) the payment would violate loan covenants or other contractual terms to which the service recipient is party, where such a violation would result in material harm to the service recipient.

- Planning Note: Plans may be amended to add such a provision, provided that the amendment is not effective for at least 12 months.

- Caution: If a plan is amended to remove such a provision with respect to amounts previously deferred, the amendment will constitute an impermissible payment acceleration.

Permitted Accelerations

General. The proposed regulations incorporate all of the permissible accelerations described in Notice 2005-1, including accelerations (1) in connection with a qualified domestic relations order, (2) to comply with a certificate of divesture, (3) to pay income taxes due upon a vesting event in a Section 457(f) plan, (4) of de minimis payments or specified amounts and (5) to pay employment taxes on deferred compensation. The regulations also permit acceleration of payments under the circumstances described below.

Income Inclusion Upon Violation of Section 409A. The proposed regulations permit a plan to provide that payments to a service provider will be accelerated to the extent needed to pay the amount the service provider must include in income as a result of the plan failing to meet the requirements of Section 409A.

Intervening Events. The proposed regulations confirm that a plan may provide that an intervening event may override an existing payment schedule already in payment status, even if it results in a more rapid payment of the service provider's total account, so long as the intervening event is also a permissible payment event under Section 409A.

- Example: A plan may provide that in the event a service provider dies or becomes disabled after installment payments have commenced, but before all payments have been made, all remaining amounts will be paid to the service provider in a single lump sum payment.

Plan Terminations. The regulations provide three circumstances under which a plan may be terminated at the discretion of the service recipient, so long as the plan provides for such terminations.

- A plan may be terminated if (1) all plans of the same type (*e.g.*, all account balance plans) are terminated with respect to all participants, (2) no payments other than those otherwise payable under the terms of the plan, without regard to the termination, are made within 12 months of termination, (3) all amounts are paid within 24 months of termination and (4) no new plan of the type terminated may be adopted for a period of 5 years following the termination date.
- A service recipient may elect to terminate a plan and make payments to the participants during the 30 days preceding or 12 months following a change in control of a corporation, provided that certain conditions are met.
- A plan may provide that it automatically terminates upon a corporate dissolution taxed under IRC Section 331, or with the approval of the bankruptcy court, provided that certain conditions are met.

Client Alert

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