BY SHAWN RICHTER

The Changed Rules for Deferred Compensation Plans

FOR MOST OF THE LAST 25 YEARS, Congress and the Internal Revenue Service have been relatively quiet concerning the rules for deferred compensation. Then, in 2004, in the wake of perceived executive compensation abuses uncovered in such high-profile cases as the Enron and Worldcom collapses, Congress enacted Internal Revenue Code Section 409A as part of the American Jobs Creation Act of 2004. Politically, Section 409A represents Congress's attempt to swing the pendulum back towards limited deferred compensation arrangements. For practitioners, it represents a dramatic change in the rules governing deferred compensation, one that has rendered obsolete much of the conventional wisdom on the subject.

In the months, weeks, and even days leading up to the Enron and Worldcom collapses, executives in the two companies resigned their positions and took their agreed-upon severance packages. These executives received, in some cases, millions of dollars in severance compensation from companies that were on the verge of bankruptcy. When the companies did, in fact, declare bankruptcy, it left shareholders, many of whom were employees of these companies, with worthless stock, which, for many of the employees, represented significant portions of their retirement planning, including their 401(k) accounts.

Many likened the behavior of some of these executives to that of insider trading, with the executives jumping ship right before it sank. These scandals led to the growing perception that some companies, as well as their executives, were benefiting from large deferred compensation arrangements well beyond the extent Congress intended, all to the detriment of both the employees of their companies and the American people, in general, in the form of lost tax revenues. Now, under Section 409A, if certain requirements are not satisfied, employees may have to include their deferred compensation in current income, subject to additional taxes and potential penalties.

Section 409A applies only to nonqualified deferred compensation. Nonqualified deferred compensation stands in contrast to qualified deferred compensation, which typically takes the form of such well-known qualified benefit plans as 401(k) plans, IRAs, most healthcare and disability plans, incentive-based stock awards, or similar arrangements. These plans are "qualified" under the Internal Revenue Code. Broadly defined, nonqualified deferred compensation is all other income, be it cash or in-kind, that has been earned by a service provider (employee or independent contractor),[1] but which will be received by the service provider in a subsequent year.[2] Section 409A details how nonqualified deferred compensation may be deferred, and once deferred, when and how it may be paid. The failure to comply with or be exempt from Section 409A can result in significant additional taxes on these amounts, in addition to applicable penalties and interest.

Compliance with Section 409A is governed by the requirements of Section 409A(a)(2), (3), and (4). A nonqualified deferred compensation plan complies with Section 409A(a)(2) if the deferred compensation may not be distributed earlier than: 1) an employee's separation from service, 2) the date the plan participant becomes dis-

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abled, 3) death, 4) a specified time or pursuant to a fixed schedule that must be specified at the time of the deferral of the compensation, 5) change in ownership, effective control, or assets of the employer corporation, or 6) the occurrence of an unforeseeable emergency.[3] Section 409A(a)(3) provides that a nonqualified deferred compensation plan or arrangement must not allow for the acceleration of the time or schedule of any payment, unless it is pursuant to a specific exception provided in the regulations. Section 409A(a)(4) requires that the employee make the initial deferral election and any permissible changes in accordance with the regulations.

The failure of a plan or deferred compensation arrangement to either comply with or be exempt from Section 409A will result in substantial taxation. First, the deferred compensation itself will be included in the employee's income in the year in which the compensation is no longer subject to a substantial risk of forfeiture, a term newly defined by Section 409A. More onerous is a 20 percent tax imposed on compensation included in income due to noncompliance with Section 409A. In addition to this 20 percent tax, if an employee fails to include the noncomplying deferred compensation in income in the correct year, Section 409A imposes interest on all unpaid taxes

Shawn Richter is an associate whose practice includes tax law, business practices, and estate planning in the Scottsdale, Arizona, office of Buchalter Nemer.

that should have been paid at the underpayment rate, plus 1 percent. Thus, failure to comply with or be exempt from Section 409A results in the immediate taxation of the deferred income, plus an additional 20 percent tax, and interest at the underpayment rate plus 1 percent on all unpaid Section 409A taxes.[4] Moreover, some states, including California, impose their own additional 20 percent tax,[5] which could result in an aggregate marginal tax rate exceeding 80 percent of the income.

One of Section 409A's most important changes is the new definition of "substantial risk of forfeiture." Section 409A provides that unless nonqualified deferred compensation either complies with or satisfies one of the limited exceptions to Section 409A, amounts deferred are currently includable in gross income to the extent they are not subject to a substantial risk of forfeiture and not previously included in gross income, rather than when the compensation is actually or constructively received as under prior law. While many practitioners may be familiar with the traditional IRC Section 83[6] definition of substantial risk of forfeiture, Section 409A does not adopt the Section 83 definition. The final regulations provide that compensation is subject to substantial risk of forfeiture if the amount is conditioned on the performance of substantial future services or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial.[7]

Notice 2007-78

Though many practitioners have never heard of Section 409A, most are familiar with the issue of stock option backdating, which has been of particular concern to many Silicon Valley companies and which raises a number of questions involving the application of Section 409A. An increasing number of lawmakers have come to view discounted stock options in a negative light because they provide the employee (often an executive) with immediate value rather than tying the benefit of the stock options to the fortunes of the company's shareholders. Section 409A attempts to provide a tax-law driven solution to this perceived problem.

In April 2007, the Treasury Department issued final regulations on the implementation of Section 409A. Pursuant to recently released IRS Notice 2007-78, companies have until the end of 2008 to amend and correct many provisions in their agreements and plans that may provide for nonqualified deferred compensation that would be subject to Section 409A, while requiring that certain other key provisions be corrected by December 31, 2007.

Section 409A is broad in scope and not only affects traditional deferred compensation plans but many other arrangements that are not thought of as deferred compensation, such as equity arrangements, employment agreements, bonus plans, severance plans, stock option plans, foreign plans, and private equity deferral arrangements. Section 409A affects rank and file employees as well as executives and members of management.

Final regulations to Section 409A provide that, "a plan generally provides for a deferral of compensation if, under the terms of the plan and 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."[8] Recognizing that there are many compensation arrangements that cause compensation to be paid in the year following the year in which the right to compensation was earned, the IRS provided a limited "short term deferral" exception for compensation that, according to the plan or agreement, may not be paid later than two months and 15 days following the later of the employer's or employee's taxable year in which the compensation is earned. Thus, for a calendar-year employer and employee, income that is not payable later than March 15 of the year following the year in which it is earned (no longer subject to a substantial risk of forfeiture) is exempt from Section 409A.[9]

Section 409A became effective on January 1, 2005.[10] The result of this effective date is that any deferred compensation that was no longer subject to substantial risk of forfeiture as of December 31, 2004 (for example, because it had vested), is not subject to taxation under Section 409A.[11] For nonqualified deferred compensation that vests or vested after December 31, 2004, the IRS has provided temporary relief from some of the provisions under Section 409A. Under Notice 2005-1,[12] relief was provided until December 31, 2005, and most of the relief was subsequently extended until December 31, 2006. The final regulations further extended many of the relief provisions until December 31, 2007, and Notice 2007-78, which was issued on September 10, 2007, has again extended many of the relief provisions until December 31, 2008.

This most recent extension, however, was in reaction to the requests of many practitioners, given the short time frame to digest and implement the 397 pages of final regulations. Given these factors, it is unlikely that the IRS will further extend the temporary relief provisions. Thus, it is recommended that companies take action to bring their plans either into compliance with, or under one of the limited exceptions to, Section 409A before December 31, 2008.

Notice 2007-78 provides limited transitional relief to the application of IRC Section 409A. The primary principle of this transition relief is that, generally, a plan or agreement will not violate the requirements of Section 409A on or before December 31, 2008, provided that the plan is operated in accordance with the requirements of Section 409A and the associated guidance, and that the written document of the plan is amended on or before December 31, 2008, to "comply with the guidance retroactively to January 1, 2008."[13] Significantly, Notice 2007-78 does not extend the deadline for designation of time and form of payment. Thus, by December 31, 2007, the timing and form of payment, such as payment upon separation from service, or pursuant to a fixed schedule, must be designated and may not be altered unless done so in compliance with the final regulations. However, the definitions of the time and form of payment may be amended until December 31, 2008, provided that as of January 1, 2008, the plan is operated in compliance with all Section 409A guidance. Notice 2007-78 provides additional guidance and therefore it is important for all practitioners to carefully examine Notice 2007-78 as soon as possible in order to determine the extent to which agreements and plans must be amended prior to January 1, 2008.

Other Provisions

Separation from service. Treasury Regulations Section 1.409A-1(h) provides that an employee is presumed to have separated from service when, based on the facts and circumstances, the employee and employer reasonably anticipate that the employee will perform 20 percent or less of the average level of service performed by the employee during the immediately preceding 36 months.[14] In contrast, when the employee's level of service continues at the rate of 50 percent or more, it will be presumed that no separation from service has occurred. No presumption applies where the decrease is to more than 20 percent but less than 50 percent. When an employee, based on the facts and circumstances, reasonably anticipates providing more than 20 percent, but less than 50 percent, of the prior average level of service, the employee will be considered to have a separation of service if a reasonable good faith amount of anticipated services to be performed by employee is detailed in writing and such amount is no more than 50 percent of the services provided by the employee over the prior 36 months.[15]

Specified employees. Generally Section 409A permits compensation to be payable upon an employee's separation from service, however, specified employees (generally the 50

highest paid employees) at a company whose stock is publicly traded are subject to additional burdens under Section 409A.[16] In particular, compensation payable in connection with separation from service generally must be deferred for six months following termination of employment.[17]

Disability. An employee is considered disabled if an employee is not able to engage in any substantial gainful activity because of physical or mental impairment that is expected to last for a period of not less than 12 months or is expected to result in the employee's death.[18] An employee will be considered disabled if the employee is determined to be totally disabled by the Social Security Administration or in accordance with the employer's disability insurance program, as long as the definition used under the disability insurance program complies with Treasury Regulation Section 1.409A-3(i)(4).

Specified time or fixed schedule. Compensation is considered to be made payable at a specified time, or pursuant to a fixed schedule, if the amount of compensation to be paid is objectively determinable and, at the time the amount is deferred, the date or dates that payments are to be made are both nondiscretionary and objectively determinable.[19] The rules surrounding the determination of a specified time or a fixed schedule are complex. If a practitioner intends to structure distributions at a specified time or on fixed payment schedule, careful examination of the rules is advised.

Change in ownership or effective control or change in ownership of assets. The rules governing change in ownership or control or change in ownership of a substantial portion of the assets of a corporation are found in Treasury Regulation Section 1.409A-3(i)(5). These rules are also vast and complex, and practitioners are cautioned that when a change-of-control acceleration of compensation is included in a plan or agreement (as is frequently the case) careful adherence to the rules contained in these regulations is advised.

Stock options. A preferred method of many companies to attract and keep employees has been the use of generous discounted stock option grants. A discounted stock option is, for Section 409A purposes, an option to purchase stock with an exercise price that is less than the fair market value of the stock on the grant date.[20] Section 409A provides that the award of discounted stock options are considered nonqualified deferred compensation. As a result, Section 409A causes the spread (the value of the stock when it is no longer subject to a substantial risk of forfeiture less the exercise price) to be included in gross income subject to the Section 409A 20 percent additional tax, interest, and applicable penalties in the year it is no longer subject to a substantial risk of forfeiture. Additionally, if in subsequent years, the value of the stock further increases, the new spread (current value of stock less previously taxed value of stock) is again includable in current income under Section 409A and subject to all applicable Section 409A taxes, interest, and penalties. All this may occur before the employee even exercises the stock option, and thus the employee may be responsible for taxes for stock options that may not be exercised for years to come, if ever.

Along with other forms of deferred compensation, the IRS has provided limited relief until December 31, 2008, to correct the exercise price of any stock options already awarded to equal what would have been the fair market value of the stock on the original grant date. This relief was only available until December 31, 2005, for certain highly compensated executives of public companies. As with other rules, the rules surrounding stock options under Section 409A are complex and require a careful reading of the final regulations and other guidance.

Stock appreciation rights. A stock appreciation right is the grant to a service provider of a right to receive as compensation (generally as a bonus) an amount equal to the appreciation in an employer's stock over a specified period of time. The treatment of stock appreciation rights under 409A is similar to the treatment of stock options. A stock appreciation right will not be considered to violate Section 409A if the right to the appreciation in the value of the stock is limited to the increase in value of the stock from the grant date to the exercise date, and the increase will be based on the fair market value of the stock.[21] Put simply, as long as the stock appreciation right is not a discounted stock appreciation right, and all other aspects of the exception are met, the compensation received on the stock appreciation right will not be taxable under Section 409A. As with stock options, a correction fixing stock appreciation rights that may be subject to Section 409A is generally possible, provided it is completed on or before December 31, 2008.

Restricted stock awards. A restricted stock award is the grant of stock to a service provider with conditions that at the time of grant have yet to be met, and if not met will result in the forfeiture of the stock award. Generally, these restrictions are based either on time or performance. For example, the award might be conditioned upon the requirement that an employee be employed with the employer for a set period of time or the attainment of certain sales or production goals. Restricted stock awards are generally not taxable under Section 409A, largely because upon the lapse of the restrictions, they are immediately taxable (or they were previ-

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ously taxed because an IRC Section 83(b) election had been made).[22]

Occurrence of an unforeseeable emergency. An "unforeseeable emergency" under Regulation Section 1.409A-3(i)(3) is a financial hardship to the employee resulting from illness or accident to the service provider, spouse, or dependents; the loss of the employee's property due to casualty; or similar extraordinary and unforeseeable circumstances "arising as a result of events beyond the control" of the employee. Distributions are limited in the case of an unforeseeable emergency to amounts reasonably necessary to satisfy the need, including amounts necessary to pay taxes and penalties attributable to the distribution.

Next Steps

Given the broad definition of deferred compensation under Section 409A, employers, employees, and their counsel need to review all arrangements and plans that may provide for deferred compensation. The following is a nonexhaustive list of compensation arrangements that should be reviewed and amended before December 31, 2007, or December 31, 2008, when applicable:

- Elective deferral arrangements.
- Excess defined benefit plans.
- Incentive plans.
- Performance-based arrangements.
- Stock options (stock options that do not have a discount exercise prices, as determined on the date of grant, are generally exempt from Section 409A).
- Stock appreciation rights.
- Employee stock purchase plans (other than those qualifying under IRC Section 423).
- Director and highly compensated employee a) compensation arrangements, b) equity awards, and c) other benefits and deferred arrangements.
- Severance plans.
- Separation arrangements.
- Fringe benefit arrangements.
- Taxable reimbursement arrangements.
- Life insurance arrangements.
- Earn-out arrangements.
- Retirement arrangements (other than those qualifying under IRC Section 401).
- Change of control agreements.

Many, if not all, of these deferred compensation arrangements and plans can be brought into Section 409A compliance, or made to fall within one of the limited exceptions to Section 409A, but all necessary modifications must be finalized before the end of 2008.

Though the additional taxation and potential interest and penalties under Section 409A are imposed on the employee rather than the employer, a sound employee-retention policy would ensure that, when possible, the effects of Section 409A are minimized or eliminated. Moreover, Section 409A imposes reporting and withholding requirements on employers. To this end, it is important for employers and their attorneys to examine all arrangements and plans that may contain deferred compensation features and ensure that these plans and arrangements will not be subject to taxation under Section 409A. Specifically, companies and their counsel should, by December 31, 2007, examine all written arrangements to ensure that they comply with Section 409A's time and form of payment requirements. Additionally, all deferred compensation arrangements must be in operational compliance with Section 409A by January 1, 2008. Although the IRS has extended the window of opportunity for correcting some Section 409A documentary deficiencies, correcting deferred compensation agreements can be a lengthy process, especially for publicly traded companies.

Given the limited time remaining to make corrections for Section 409A, and given that many companies and their executives are often slow to heed the warnings of their counsel, it is advisable that persistent efforts be made in order to ensure that the necessary corrections are made in a timely manner. Practitioners should assist their clients in examining all existing deferred compensation arrangements—before the end of the year if possible. Lastly, it is incumbent upon the practitioner to be vigilant that all new arrangements and plans are drafted and operated in a manner that either complies with, or is exempt from, Section 409A. ■

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[1] I.R.C. §409A uses the terms "service provider" and "service recipient" in order to avoid limiting its application to employees and employers. Thus, independent contractors (such as members of boards of directors) are covered. Also, partners and partnerships are covered under Section 409A; however, the final regulations reserve discussion of this subject. For current guidance on the treatment of partners and partnerships *see* I.R.S. Notice 2005-1, question and answer 7.

[2] Treas. Reg. §1.409A-1(b)(1).

[3] I.R.C. §409A(a)(2)(i) through (vi).

[4] I.R.C. §409A(a)(1)(B).

[5] Rev. & Tax. Code §17501.

[6] I.R.C. §83(c)(1).

[7] Treas. Reg. §1.409A-1(d)(1).

[8] Treas. Reg. §1.409A-1(b)(1).

[9] Treas. Reg. §1.409A-1(b)(4).

[10] American Jobs Creation Act of 2004, P.L. 108-357 (2005).

[11] Treas. Reg. §1.409A-6(a)(1)(i).

[12] I.R.S. Notice 2005-1.

[13] I.R.S. Notice 2007-78.

[14] Treas. Reg. §1.409A-1(h)(1)(ii).

[15] *Id.*

[16] I.R.C. §409A(a)(2)(b)(i); Treas. Reg. §1.409A-1(i).

[17] *Id.*

[18] Treas. Reg. §1.409A-3(i)(4)(i).

[19] Treas. Reg. §1.409A-3(i)(1).

[20] Treas. Reg. §1.409A-1(b)(5)(i)(A).

[21] Treas. Reg. §1.409A-1(b)(5)(i)(B).

[22] I.R.C. §83(b).