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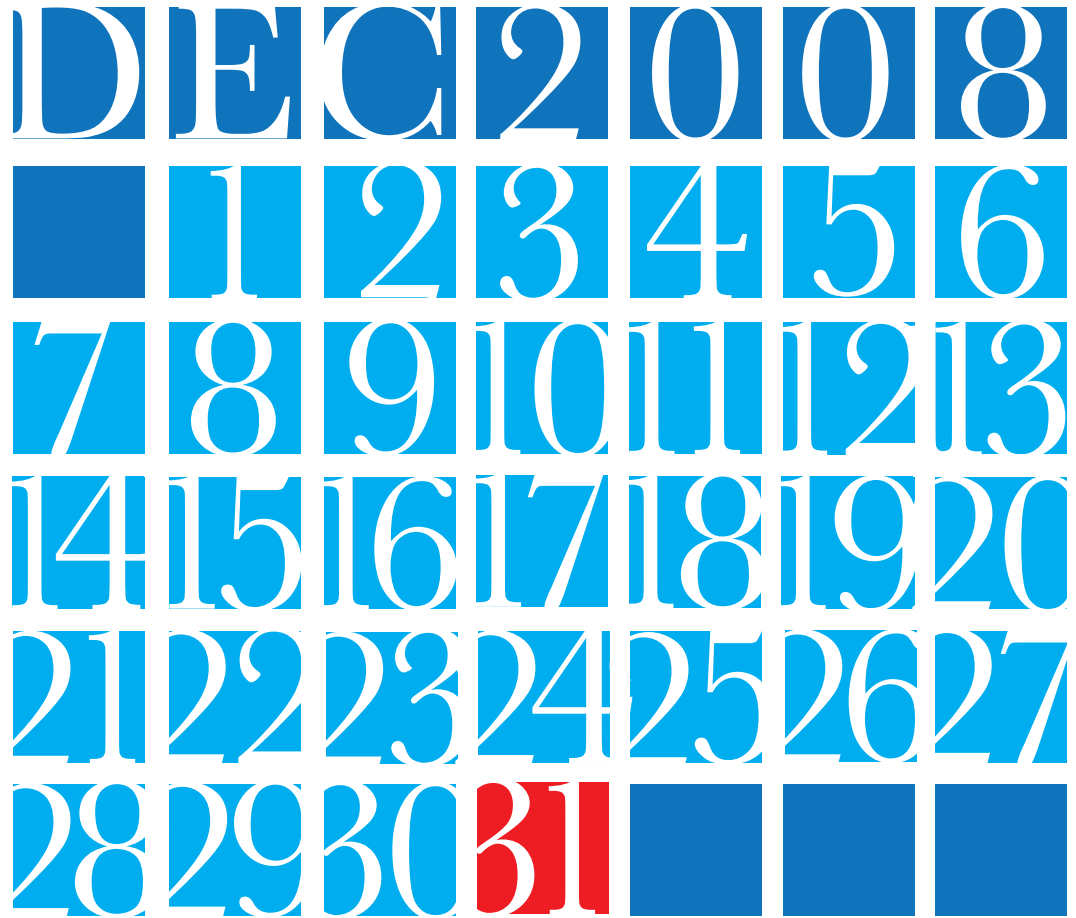
The AALU
Quarterly



By Marla Aspinwall
*Loeb & Loeb, LLP
Los Angeles, California
AALU Nonqualified Plans
Committee
AALU member since 2003*



By Michael Goldstein, JD, LLM
*The Newport Group
Newport Beach, California
AALU Nonqualified Plans
Committee
AALU member since 1992*



SECTION 409A

What Your Clients Need to Know Before 2009

The American Jobs Creation Act of 2004 (the “Jobs Act”) has radically changed not just traditional retirement and nonqualified deferred compensation arrangements, but many other types of arrangements as well. You have an opportunity to gain the trust and respect of your clients by warning them that they need to review their other executive compensation arrangements for compliance with Section 409A of the Internal Revenue Code (“Section 409A”) before the end of this year to avoid acceleration of taxes and excise taxes.¹ The new rules impact employment agreements, equity, incentive, participation, severance and change in control arrangements and even some welfare benefit plans in often counterintuitive ways that will plague employers and executives for some time. However, many companies have only focused on a review of their nonqualified deferred compensation and supplemental retirement plans for Section 409A compliance. With the effective date of December 31, 2008 looming ahead, it is necessary for every employer to have a plan of action to review all relevant executive arrangements.

Application of Section 409A

Section 409A applies to every arrangement that has the effect of deferring compensation, other than those arrangements which are specifically exempted such as qualified plans and bona fide vacation leave, sick leave, compensatory time, disability pay and death benefit plans.² It is also important to note that Section 409A applies not only to employees but also directors and independent contractors providing 70% or more of their services to the same company.³

The regulations provide that the new rules are not intended to apply to bonus plans or other compensation arrangements where compensation is paid within two and a half months after the close of the later of the taxable year of the employee or the employer in which the right to the compensation is earned and vested (the “Short Payment Period”).⁴ However, to the extent that a compensation arrangement provides for payments beyond this period or payments are actually made beyond this period, the arrangement will be subject to the new rules and potential excise taxes. Final regulations

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provide that if the arrangement does not specify the timing of the payments and payments are in fact made within the Short Payment Period, the payments will not be treated as deferred compensation subject to Section 409A. However, if payments are not made within the Short Payment Period they will be subject to Section 409A and may, therefore, have failed to comply with the requirements and be subject to an excise tax unless the delay is due to unforeseeable administrative impracticality, would jeopardize the ability of the employer to continue as a going concern or would not be deductible under Section 162(m).⁵ Thus, it is important that all compensation arrangements now specify the timing of all payments in order to avoid the inadvertent application of Section 409A.

The Short Payment Period discussed above commences upon the “vesting” of the right to the payment. Vesting occurs when a payment is no longer subject to a “substantial risk of forfeiture.” The final regulations include a new definition of “substantial risk of forfeiture” and provide that compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial.⁶ Interestingly, the new rules provide that substantial risks of forfeiture added after the beginning of the service period to which the compensation relates are disregarded for purposes of determining whether the compensation is subject to a substantial risk of forfeiture (i.e., rolling risks of forfeiture will not work). In addition, unlike the substantial risk of forfeiture standard that applies under Section 83, an amount is not subject to a substantial risk of forfeiture under Section 409A merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from performance of services. Thus, non-competes will not constitute a substantial risk of forfeiture under the Section 409A definition.

Final regulations also provide that an amount will not be considered subject to a substantial risk of forfeiture beyond the date or time at which the recipient otherwise could have elected to receive the amount of compensation, unless the amount subject to a substantial risk of forfeiture (ignoring earnings) is materially greater than the amount the recipient could have elected to receive. As a result, a salary deferral generally may not be made subject to a substantial risk of forfeiture. Final regulations clarify that amounts that may be paid on termination “for good reason” are subject to a substantial risk of forfeiture.⁷ Good reason is defined under the regulations to include material changes such as diminution in base compensation, authority, duties, title, budget, change in work location, or material breach of contract terms. The regulations include a safe harbor which requires the employee to notify the employer of the good reason condition within 90 days of the occurrence and to give the employer at least 30 days to cure.⁸

Many types of payments under offer letters, employment and consulting agreements, and compensation agreements or policies may be subject to Section 409A. It is, thus, important to specify the timing of each type of payment to either

¹ If a plan fails to meet all of the written requirements or is not operated according to the rules, all the compensation under all arrangements within the same class for the taxable year and all preceding years is includible in gross income in the taxable year it is no longer subject to a substantial risk of forfeiture. Additionally, the taxable amount is increased by interest for the entire time the plan is not in compliance and a federal excise tax of 20% is then added. Additional state taxes may also be added; for example, California adds an additional 20% excise tax on the whole. The penalties are imposed individual by individual, so every participant in a plan will not be affected by a violation applicable to only one participant.

² See Treas. Reg. Section 1.409A-1.

³ See Treas. Reg. Section 1.409A-1(f). For independent contractors who happen to provide more than 70% of their services to a single recipient in just one year, final regulations provide a 3 year look back which would prevent application of Section 409A in such instances.

⁴ See Treas. Reg. Section 1.409A-1(b)(4). IRS Notice 2007-86 provides flexibility for 2008 bonus deferrals but as of January 1, 2009 that flexibility is gone.

⁵ See Treas. Reg. Section 1.409A-1(b)(4)(ii).

⁶ See Treas. Reg. Section 1.409A-1(d).

⁷ See Treas. Reg. Section 1.409A-1(n)(2).

⁸ See Treas. Reg. Section 1.409A-1(n)(2)(ii).

exclude it from application of Section 409A as within the Short Payment Period or comply with Section 409A specified payment date requirements.

Bonus and Performance Plans

Annual bonus plans should not be subject to Section 409A to the extent that bonus payments are made within the Short Payment Period. However, it is safest to specify both the timing of the vesting and the timing of the payment in the bonus plan documents or an employment agreement in order to avoid confusion about the application of Section 409A and the applicable Short Term Payment Period. To the extent that a multi-year bonus plan or other arrangement provides for the payment of compensation beyond the Short Payment Period, it will be subject to the new rules. Also, to the extent that voluntary deferral plans allow the deferral of bonus amounts, it may be necessary to make sure the bonus plans comply with the definition of “performance based compensation” under the new rules to enable the deferral of bonuses six months before completion of the performance period.

Participation Rights, Commissions and Royalties

In some cases it is not clear how Section 409A may be applied to compensation which is based on a right to participate in amounts received by the company in the future as a result of a formula or other method of sharing earnings or production where no additional services are required from the employee to be entitled to such participation. It is clear in final regulations that for purposes of deferral elections, the employer may treat commissions as earned either at the time the services on which such commissions are based are completed or at the time payment is received, as long as the treatment is consistent.⁹ However, the preamble to the regulations suggests that generally commission arrangements will not be considered deferred compensation “. . . where a commission arrangement requires that the service provider be providing services at the time of the payment to be entitled to the payment, the commission is paid in the normal course, and neither the service provider nor the service recipient has a right to specify a payment date.”¹⁰ The IRS Chief Counsel’s office recently addressed the timing of vesting of renewal commissions in the context of the payment of employment taxes. While it concluded that renewal commissions constituted deferred compensation because the agent has a binding legal right to such amounts, it also concluded that the renewal commissions were subject to a substantial risk of forfeiture under Section 83.¹¹

This analysis is consistent with the discussion in final Section

409A regulations regarding the definition of “legally binding right.” The final regulations indicate that if the company or some other person unrelated to the employee has a unilateral right to reduce or eliminate compensation, the employee will not be considered to have a legally binding right to such compensation. While, an objective nondiscretionary formula will not be considered a unilateral right preventing an employee from having a legally binding right to compensation, the regulations specify that such an objective formula may create a substantial risk of forfeiture.¹² Therefore, it makes sense that participation rights and royalties determined by an objective formula after all required services have been performed, should not be considered “vested” for purposes of application of the Short Term Payment Period at least until the amounts on which such rights are based are fixed and determinable. However, given the lack of clear guidance on this issue, practitioners are generally advising compliance of such arrangements with Section 409A just to be safe by specification of fixed payment dates.

Employment, Severance and Change in Control Arrangements

It is important to specify the timing of severance and change in control payments to either exclude them from application of Section 409A or to comply with its requirements. Severance payments also must not change, accelerate or replace payments under other benefit arrangements in violation of Section 409A. The timing of severance payments and change in control payments may no longer be in the discretion of the employer. Separation arrangements entered into at the time of termination should also specify the timing of payments at the time the legal right to such payment is established and must be careful to not change, accelerate or replace payments under other arrangements in a way that violates Section 409A.

For public companies, severance and change in control provisions should address the application of the required six-month delay in severance payments to specified key employees. Application of the six-month delay requirement may be avoided by specifying payments to be made within the Short Payment Period or carving out “involuntary severance.” Amounts payable on “involuntary severance” or termination for “good reason” up to specified limits are exempt from Section 409A.¹³ Involuntary separation payments are limited to two times the lesser of total prior year compensation or two times the section 401(a)(17) limit (e.g., \$460,000 for 2008) paid prior to the end of the second year following termination. Final regulations clarify that even if severance is above this limit, amounts quali-

⁹ See *Treas. Reg. Section 1.409A-2(a)(12)*.

¹⁰ See *Section VI.G of the preamble to final regulations under Code Section 409A, 26 CFR Part 1, T.D. 9321 (April 17, 2007)*.

¹¹ Basically the IRS concluded that, because renewal commissions are not paid unless the insured pays the premiums for the renewal and because that is a condition related to the deferred compensation, the amounts were subject to a substantial risk of forfeiture. The IRS particularly relied on an example in the Section 83 regu-

lations stating that stock transferred to an underwriter prior to a public offering is subject to a substantial risk of forfeiture until the public offering is successful. *CCA 200813042 (Dec. 17, 2007)*.

¹² See *Treas. Reg. Section 1.409A-1(d)*.

¹³ See *Treas. Reg. Section 1.409A-1(n)*.

¹⁴ See *Treas. Reg. Section 1.409A-1(b)(9)(v)(B)*.

The timing of severance payments and change in control payments may no longer be in the discretion of the employer.

fyng as involuntary severance (i.e., the first \$460,000 for 2008) may be carved out and thus paid within the first six months even if the six-month delay requirement is otherwise applicable. The continuation of most forms of benefits over the first two years after termination of employment or the payment of COBRA premiums will generally not be subject to Section 409A or may comply by specification of the payment schedule.¹⁴

Tax Gross-up Payments

Tax gross-up payments often connected to golden parachute payments after a change in control will generally be subject to Section 409A unless made within the Short Payment Period. However, final regulations provide that the contract will comply with Section 409A requirements if it provides that tax gross up amounts will be paid by the end of the employee's tax year next following the tax year in which the employee pays the taxes.

Stock Options

The grant of a stock option, stock appreciation rights ("SAR"), or other equity-based compensation may provide for deferral of compensation that is subject to the new rules subject to the following limitations:¹⁵ The grant of incentive stock options under Section 422 and the grant of an option under an employee stock purchase plan under Section 423 do not constitute deferrals of compensation under Section 409A. All other options to purchase stock of the service recipient will not constitute deferrals of compensation only if all of the following requirements are satisfied: (A) the exercise price is not and cannot become less than the "fair market value" of the underlying stock on the grant date, (B) the optioned stock is "common stock" without preferences (other than on liquidation), (C) the optioned stock is stock of the service recipient or a 50% parent entity (or any entity up--not down--the 50% ownership chain and may be 20% if employee has business nexus to optioned company), and (D) the option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of exercise or disposition of the option. For purposes of determining the fair market value of stock at the date of grant, the regulations include valuation rules which are likely to become very important. Public companies must base the exercise price on a reasonable valuation method using actual sales such as last sale, closing price or average price on day before or day of grant and may use an average over a specified period but only if the period is specified

in advance and an irrevocable commitment to make the grant precedes the valuation period. Private companies must use "reasonable application of reasonable valuation methods" based on factors such as asset values, anticipated cash flows, stock value of comparable entities, recent arm's length sales, and valuation meth-

ods used for other non-compensatory reasons. Regulations include safe harbors for (i) independent appraisals within the prior 12 months, (ii) a repurchase formula generally applicable for compensatory and non-compensatory purposes that qualifies as fair market value under Section 83, or (iii) in the case of a start-up company, valuation of a "qualified individual" (five years experience in business valuation, appraisal, finance, investment banking, secured lending, etc.) applied at a time when no change of control (within 90 days) or public offering (within 180 days) is anticipated.

Stock Appreciation Rights

Final regulations provide that the grant of a SAR for the stock of the service recipient, like an option, does not constitute a deferral of compensation if the SAR exercise price is not less than the fair market value of the underlying stock on the date the SAR is granted, and the SAR does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the SAR.¹⁶

Restricted Stock Grants

Final regulations provide that there is no deferral of compensation if a service provider receives property merely because the value of the property is not includible in income (under Section 83) in the year of receipt by reason of the property being nontransferable and subject to a substantial risk of forfeiture, or is includible in income (under Section 83) solely due to a valid election under Section 83(b). However, Section 409A does apply to the receipt of a legally binding right to receive property (whether or not the property is restricted property) in a future year. Thus, restricted stock units or phantom stock will generally be subject to the new rules, while restricted stock will not (assuming the requirements prescribed above are satisfied).¹⁷

Partnership Interests

Final regulations provide that while Section 409A will apply to compensation deferral arrangements between a partner and a partnership, until further guidance is issued, an issuance of or grant of an option to purchase a partnership interest in connection with the performance of services will

¹⁵ See *Treas. Reg. Section 1.409A-1(b)(5)*.

¹⁶ See *Treas. Reg. Section 1.409A-1(b)(5)(i)(B)*.

¹⁷ See *Treas. Reg. Section 1.409A-1(b)(6)*.

be treated in the same manner as an issuance or option grant of stock.¹⁸ Recently it has become popular to grant executives a “profits interest” in the employing entity or a subsidiary entity in exchange for services. While there have been some discussions about the appropriate tax treatment of such interests,¹⁹ the final regulations do not suggest that profits interests should be treated as deferred compensation under Section 409A.

Reimbursement Arrangements

The final regulations clarify that a legally binding right to receive a nontaxable benefit does not provide for a deferral of compensation for purposes of Section 409A, such that most medical or business expense reimbursement plans and plans providing nontaxable in-kind benefits will not be subject to Section 409A. In addition, Section 409A exempts post retirement reimbursements which are (i) reimbursements that are excludible from income; (ii) reimbursements for deductible business expenses; (iii) reasonable outplacement and moving expenses actually incurred related to the termination of services; and (iv) deductible medical expenses actually incurred by the employee, if they are incurred and reimbursed by the end of the second calendar year following separation from service.²⁰ Section 409A does cover reimbursement constituting taxable income to employees such as tax preparation services and country club dues, but such arrangements may be structured to meet the requirement of a fixed time and form of payment under Section 409A if reimbursement allowances are not carried over between years and reimbursed amounts are paid prior to the end of the calendar year following the year in which the expenses are incurred.²¹

Welfare Benefit Plans

Vacation leave, sick leave, compensatory time, disability pay or death benefit arrangements are generally not nonqualified deferred compensation subject to Section 409A. In addition, certain nontaxable medical reimbursement arrangements (including a health reimbursement arrangement) are excluded. However, Section 409A may apply under some circumstances to certain split dollar arrangements as well as certain welfare benefits provided to former employees more than two years after termination of employment.²²

Because many payments provided under existing employment contracts, including severance payments, are not currently vested, most contracts will not be grandfathered under Section 409A transition rules which apply to amounts vested prior to January 1, 2005. Thus, all existing contracts should be reviewed for compliance with Section 409A. Existing contracts are required to be operated in good faith compliance with new rules now and must be amended to comply with the new rules by December 31, 2008. Thus, it is important that your clients have an immediate plan of action to review all relevant executive compensation arrangements for compliance with Section 409A.


¹⁸ See *Treas. Reg. Section 1.409A-1(b)(7)* which is reserved and *Section III.G of the preamble to the final regulations*. T.D. 9321 (April 17, 2007).

¹⁹ *Proposed partnership regulations under Section 83 would allow profits interests to be valued at the time of grant at liquidation value which is generally zero such that future receipts would receive capital gains treatment. Many have argued that such interests are the same as performance bonuses such that receipts should be taxed like compensation at ordinary income rates.*

²⁰ See *Treas. Reg. Section 1.409A-1(b)(9)*.

²¹ See *Treas. Reg. Section 1.409A-3(i)(1)(iv)*.

²² See *Treas. Reg. Section 1.409A preamble Section III. M and IRS Notice 2007-34*.

This article is not intended to provide legal advice but is merely a brief summary of recent developments which may warrant attention. The article was not intended or written to be used, and it cannot be used, for the purposes of avoiding any penalty that may be imposed by the internal revenue service. The article was not written to support the promotion or marketing of the transactions or matters addressed herein, and, based on the particular circumstances, you should seek advice from an independent tax advisor. 

ABOUT THE AUTHORS

The article was submitted by Marla Aspinwall Esq. and Michael Goldstein Esq., who are both members of the AALU Nonqualified Plans Committee. Marla Aspinwall is an executive compensation and benefits attorney with Loeb & Loeb LLP in Los Angeles, California. She may be contacted at Loeb & Loeb LLP, 10100 Santa Monica Boulevard, Suite 2200, Los Angeles, CA 90067, (310) 282.2200, maspinwall@loeb.com. Michael G. Goldstein JD, LL.M. is the Senior Vice President & Counsel at the Newport Group, a leading full-service provider of qualified and nonqualified plans and investment advisory services. Mike may be reached at (949)760-9098 or mgoldstein@newportgroup.com.