

IRC Section 409A



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April 26, 2007

409A History and Status

- Added to the Internal Revenue Code in October, 2004, as part of the American Jobs Creation Act of 2004 (Section 885 of Public Law 108-357)
- Post-Enron provision, intended to curb perceived abuses in executive's access to deferred compensation benefits
- Responds to/reflects IRS' long-standing skepticism regarding deferred compensation

409A History and Status

- Important Guidance
 - IRS Notice 2005-1 (initial guidance and transition rules, issued 12/20/04)
 - Proposed Regulations (issued 10/03/05)
 - IRS Notice 2006-79 (transition rules)
 - Final Regulations (issued 4/17/2007, generally effective 1/1/08)

409A History and Status

- Other Guidance
 - IRS Notice 2005-94 (reporting and withholding transition guidance)
 - IRS Notice 2006-4 (stock rights transition guidance)
 - IRS Notice 2006-33 (trust transition guidance)
 - IRS Notice 2006-64 (conflict of interest payments)
 - IRS Notice 2006-100 (additional reporting and withholding transition guidance)

409A History and Status

- Where are we now?
 - Final 409A regulations effective 1/1/08
 - Plans must comply with the final regulations in form and operation before 1/1/08
 - “Transition period” through end of 2007
 - Plans must operate in “good faith compliance” with 409A
 - Can rely on final regulations, proposed regulations, or IRS Notice 2005-1

Overview of Section 409A

- Applies to “nonqualified deferred compensation plans”
- Is generally effective for compensation deferred on or after January 1, 2005 (and earlier deferrals not vested by then)
- Restricts timing of deferrals into the plan

Overview of Section 409A

- Restricts access to amounts deferred
- Prohibits acceleration of distributions
- Prohibits offshore trusts and trusts that have insolvency triggers
- Adds new reporting requirements

Section 409A, In Detail

- Plans Excluded



- Plans and arrangements excluded from 409A
 - A qualified employer plan, i.e.:
 - Qualified retirement plan or annuity
 - 403(b) plan
 - SEP or Simple Retirement Account
 - 457(b) plan (“eligible” plan for governments/tax-exempts)
 - 415(m) plan (excess benefit plan for governments)

Section 409A, In Detail

- Plans Excluded



- Certain Foreign Arrangements
 - Compensation covered by treaty
 - Certain benefits under broad-based foreign plans
 - Tax Equalization Arrangements

Section 409A, In Detail

- Plans Excluded



- Certain Welfare Benefit Plans
 - Vacation leave, sick leave, compensatory time
 - Disability pay
 - Death benefit
 - Health reimbursement

Section 409A, In Detail

- Plans Excluded



- Certain arrangements with independent contractors if:
 - Service provider is actively engaged in business of providing such services
 - Service provider provides significant services to 2 or more service recipients (unrelated to service provider or each other)

Section 409A, In Detail

- Plans Excluded



- The exception for independent contractors does not apply to:
 - Board members
 - Management-type services (control over operational or financial aspects of the service recipient)

Section 409A, In Detail

- Definition of Deferred Compensation

- What is “deferred compensation?”
 - Service provider must have a legally binding right to compensation payable in a future year.
 - A service provider is considered to have a legally binding right to compensation even if it is subject to vesting restrictions or it is offset by qualified plan benefits.
 - A service provider does not have a legally binding right to compensation if it can be reduced unilaterally or eliminated by the service recipient.
 - In general, a legally binding right to earnings on deferred compensation arises at the same time as for the compensation (to which the earnings relate).

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation



- Exceptions
 - Amounts paid after year-end pursuant to normal payroll practices

Section 409A, In Detail

-Exclusions from Definition of Deferred Compensation

– Short-term deferrals

- Amount that is paid within 2-1/2 months after the year in which it is no longer longer subject to a “substantial risk of forfeiture”
- Can use employer’s year if ends later than employee’s year

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation

- “Substantial risk of forfeiture” generally has the same meaning as in Section 83, except that
 - non-competes do not constitute a substantial risk of forfeiture
 - additions or extensions of forfeiture risk after legally binding right arises will not be recognized
 - amounts will not be considered subject to forfeiture after available in cash unless the compensation, ignoring earnings, is substantially greater than original amount

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation

- Exception made for payments after end of 2-1/2 month period
 - Certain unforeseeable events
 - Payment would jeopardize employer's ability to continue as a going concern
 - Inability to deduct payment under Section 162(m) (if application of 162(m) was unforeseeable)

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation



- Additional Considerations
 - Short-term deferral rule will not apply if plan provides that payment may be made later than the 2-1/2 month period, even if payment is actually made within the 2-1/2 month period
 - May want to assume that 409A applies and specify payment date to avoid unintended violations

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation



- Certain Types of Equity-Based Compensation
 - Incentive Stock Options and Rights to Purchase Stock under ESPPs (assuming there are no modifications)

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation



- Nonqualified Stock Options, but only if they:
 - Are for stock of the service recipient
 - Have an exercise price not less than the stock's fair market value at the time of grant
 - Do not contain any feature for the deferral of compensation

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation

- Stock Appreciation rights, but only if:
 - They are with respect to stock of the service recipient
 - Compensation payable can't exceed the difference between the stock's fair market value on exercise and its fair market value on grant
 - They do not contain any feature for the deferral of compensation

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation

- Service Recipient Stock is common stock of an “eligible issuer” (may include ADRs, mutual fund units and interests in other entities)
- “Eligible Issuer”
 - Corporation for which the service provider provides direct services or any controlling “upstream” corporation
 - Generally, 50% is controlling interest, but may be as low as 20% where based on “legitimate business criteria”

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation



- “Fair Market Value”
 - Public Stock
 - » Price at last sale before or first sale after grant date
 - » Closing price on trading date before grant date or on grant date
 - » Arithmetic mean of prices on trading date before grant date or on grant date
 - » Another reasonable method using actual transaction prices

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation

- Non-public stock

- » Use “reasonable application of a reasonable valuation method” considering: (1) value of tangible and intangible assets; (2) present value of future cash flows; (3) market value of equity in similar corporations; (4) other relevant factors, such as control premiums, discount for lack of marketability; and whether valuation method is used for other purposes. Valuation method is presumed reasonable if it is: (1) conducted by an independent appraiser under ESOP rules; (2) constitutes fair market value under 1.83-5; or (3) for start-up companies, is made pursuant to a written report that takes into account above factors.

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation

- Modifications, extensions, substitutions and assumptions of stock rights
 - Modification. If an option or SAR is modified, the modification is treated as the grant of a new option or SAR
 - » Modification - any change in the option or SAR that results in a reduction in the exercise price
 - » May or may not result in the option or SAR being subject to 409A (depends on whether the new right falls within the stock right exception)

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation

– Extension

- » Extension – provision of additional time to exercise option or SAR, conversion or exchange to a right to compensation in the future, addition of a deferral feature, and includes renewals of rights
- » Option or SAR is treated as having an additional deferral feature from the original date of grant (and therefore subject to 409A from the grant date)

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation

- Change in an option or SAR is not treated as an extension if:
 - » “Underwater” rights. At the time the change occurs the exercise price is greater than or equal to the stock’s then fair market value. Instead, the original stock right is treated as “modified”
 - » The option or SAR is exercisable no later than the date it could have expired, or if earlier, 10 years from grant

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation

- Expiration date is tolled to comply with applicable law
- Exercise would jeopardize the ability of the service recipient to continue as a going concern
- Extensions before 4/10/07.

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation

- Substitutions and Assumptions

- » Substitutions and assumptions of options and SARS in connection with a corporate transaction will not be treated as the grant of new options or SARs if the ratios of exercise price to stock's fair market value does not increase

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation



- Additional benefits
 - Dividends. Right to dividends on stock subject to options and SARs is treated as a reduction in the option/SAR exercise price, causing loss of the exemption to 409A, if the dividend right is contingent directly or indirectly on the exercise of the options/SARs

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation

- Deferral features. Any right (other than the right to receive stock or cash on exercise) provided under an option or SAR that provides for the deferral of compensation causes the option or SAR to lose the 409A exemption
- Addition of discretion. If an option or SAR is modified to allow the holder to receive an additional benefit at the discretion of the service recipient and the benefit if added would be an extension or modification, adding the discretion, itself, is a modification or extension

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation

- Transfers of restricted property (e.g., restricted stock) and beneficial interest in Section 402(b) trusts
 - Note, this exception requires a current transfer. A promise to transfer in the future is generally subject to 409A

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation



- Separation Pay
 - Collectively-bargained arrangements
 - Payment on “Involuntary” Separation or under a Window Program
 - Payment must be made by December 31 of the second calendar year following year of separation
 - Payment can’t exceed lesser of two times: (1) annual compensation for the calendar year before year of separation; or (2) the 401(a)(17) limit for year of separation

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation

- Whether termination is “involuntary” is based on the facts and circumstances
 - Look to separation documentation and other factors
 - “Good reason” termination can be “involuntary” if “good reason” is defined to require actions taken by the service recipient that have a material negative change to the service provider in the service relationship, e.g. change in:
 - Duties, conditions under which duties are performed, compensation

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation

- Other factors that are considered include:
 - » Extent to which separation payments are in the same amount and are paid at the same time/form as for involuntary terminations, and
 - » Whether service provider must give notice to the service recipient and an opportunity to cure

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation

- “Good reason” safe harbor:
 - Plan must provide that separation occurs within a predetermined period (not longer than 2 years) following a material change in one or more of the following:
 - » Diminution in (1) base compensation; (2) authority, duties or responsibility of service provider or his/her supervisor; (3) budget under service provider’s control;
 - » Change in geographical location;
 - » Breach of agreement by service recipient;

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation

- Amount, form and payment must be substantially identical to an actual involuntary separation
- Service provider must be required to provide notice to the service recipient within 90 days after condition arises and give service provider at least 30 days to cure

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation



- Reimbursements and Other Payments
 - » Reimbursements for expenses incurred by the end of the 2nd year following separation of:
 - » (1) deductible business expenses; and
 - » (2) reasonable outplacement and moving expenses

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation

- » Reimbursements of medical expenses during COBRA period;
- » De minimis (up to 402(g) limit) payments

Section 409A, In Detail

- Exclusions from Definition of Deferred Compensation



- Indemnification and liability insurance plans
- Legal settlements
- Certain education benefits

Section 409A, In Detail

Summary of Covered Compensation



- Summary of compensation subject to 409A
 - All plans that have a deferral feature other than those described above, including:
 - All nonqualified deferred compensation plans, including SERPs, excess benefit plans, other plans that provide supplements to qualified retirement plans, 457(f) plans (“ineligible” plans for governments and tax-exempts)
 - Phantom stock plans, restricted stock unit plans, discounted stock options and SARS, and options in non-service recipient stock
 - Bonus plans (that don’t satisfy the short-term deferral exception)
 - Severance plans and employment agreements with severance features (that don’t satisfy the short-term deferral or severance plan exceptions)

Section 409A, In Detail

Plan Requirements



- Plan requirements
 - The term “plan” applies to an agreement, method or arrangement, including for one person
 - The term “plan” is applied
 - Separately to each participant (as if there were a separate plan for each participant), and
 - Separately for different types of plans with like plans aggregated

Section 409A, In Detail

Plan Requirements



- Types of “plans”
 - Elective deferral
 - Other account balance (including matching)
 - Non-account balance
 - Separation pay
 - In-kind benefits or reimbursements
 - Split dollar
 - Modified foreign earned income
 - Stock rights (options and SARs)
 - Other

Section 409A, In Detail

Plan Requirements



- To satisfy 409A, the arrangement must be established and maintained by the service recipient in both form and operation
- An arrangement is considered to be established on the latest of:
 - The date it is adopted;
 - The date it is effective; or
 - The date its material terms are set out in writing

Section 409A, In Detail

Plan Requirements



- A plan will be considered to be established as of the date that a service provider has a legally binding right to compensation if:
 - It is established by the end of the calendar year in which the right arises; or
 - For amounts not payable in the year following the year that the right arises (the “subsequent year”), it is established by March 15th of the subsequent year.

Section 409A, In Detail

Plan Requirements



- Plan documentation requirements
 - Amount (or method or formula for determining amount) of deferred compensation
 - Time and form of payment
 - If deferral elections or subsequent deferrals elections permitted, the conditions under which the election may be made
 - Six-month delay rule for specified employees

Section 409A, In Detail

- Deferral Election Rules



- Deferral Elections
 - General rule

- Deferral elections must be entered into no later than the last day of the calendar year immediately before the year the services are performed for which the right to the compensation arises
- An election to defer includes an election as to the time and form of payment, but not the medium of payment
- Future earnings on amount deferred is part of deferral as long as the income is reasonable

Section 409A, In Detail

- Deferral Election Rules



– Exceptions

- Short-term Deferrals

- Elections may be entered into 12 months before forfeiture restriction lapses, as long as distribution will not commence for at least five years
- Exception to five-year requirement for death, disability, unforeseeable emergency, and change in control

Section 409A, In Detail

- Deferral Election Rules



- Forfeitable Rights

- If compensation is subject to a forfeiture restriction that lasts at least 12 months, an election may be entered into within 30 days after service recipient obtains a legally binding right to the compensation, as long as the election is made at least 12 months before the forfeiture restriction lapses

Section 409A, In Detail

- Deferral Election Rules



- Fiscal year compensation
 - May enter into election by end of fiscal year preceding fiscal year that services are performed, but only for “fiscal year compensation,” i.e., compensation relating to, and payable after the close of, one or more fiscal years

Section 409A, In Detail

- Deferral Election Rules



- New participants
 - May enter into election within 30 days after becoming eligible to participate in “plan,” but only with respect to services performed after the election.
 - For bonus-type compensation must prorate amount that may be deferred
 - If no service provider election, plan must state time and form of payment within 30 days after eligibility

Section 409A, In Detail

- Deferral Election Rules

- “Plan” mean any “409A plan” required to be aggregated with the plan
- A service provider is eligible to participate when he/she is first eligible to accrue a benefit
- Renewal of “initial eligibility”
 - » If all plan payments made and cease eligibility before last payment, on date eligible again
 - » If cease eligibility without full payment, 24 months after cessation of eligibility

Section 409A, In Detail

- Deferral Election Rules Detail

- Excess Benefit Plans (other than elective plans)
 - » “Initially eligible” to participate on first day of year following year first accrues a benefit

Section 409A, In Detail

- Deferral Election Rules



- “Performance-based compensation”
 - May enter into election no later than 6 months before the end of the performance period, provided
 - » service provider performs services continuously from date performance criteria established (or, if later beginning of performance period) until date of deferral election
 - » at time of election compensation is not yet “readily ascertainable”

Section 409A, In Detail

- Deferral Election Rules



- “Readily ascertainable”
 - » Substantially certain to be paid, in the case of a specified or calculable amount
 - » Where amount is not specified or calculable, when the amount is both calculable and substantially certain to be paid

Section 409A, In Detail

- Deferral Election Rules

- “Performance-based compensation” is compensation where:
 - » Payment is contingent on the satisfaction of pre-established organizational or individual performance criteria over a period of at least 12
 - » Criteria are “pre-established” if they are established in writing not later than 90 days after the beginning of the performance period, provided the outcome is substantially uncertain at that time

Section 409A, In Detail

- Deferral Election Rules



- » Compensation is performance-based compensation if it is based solely on an increase in the value of the service recipient or stock of the service recipient after the date of the award

Section 409A, In Detail

- Deferral Election Rules

- Nonqualified plans linked to qualified plans. Increases to “excess-type” or “offset” nonqualified benefits resulting solely from the following are not elective deferrals:
 - Changes in benefit limitations required by law under the related qualified plan
 - Elections to receive or not receive a subsidized or ancillary benefit under the related qualified plan
 - Amendment of the related qualified plan to add or remove a subsidy or ancillary benefit or to freeze or cease accruals

Section 409A, In Detail

- Deferral Election Rules

- » Changes in elective deferrals under the related qualified plan as long as the increase for the nonqualified plan is not more than the 402(g) limit
- » Action or inactions under related qualified plan with respect to elective deferral and after-tax contributions that affects matching contributions under nonqualified plan, as long as the matching contributions do not exceed 100% of the amount that would have been contributed under the qualified plan (without the qualified plan limitations)

Section 409A, In Detail

- Deferral Election Rules



- Separation Pay
 - Where separation pay is the subject of bona fide arms length negotiations, a deferral election may be entered into any time up until the service provider obtains a legally binding right to the payment
 - Where payments are made under a “window program” a deferral election may be entered into at any time before the election to participate in the window program is irrevocable

Section 409A, In Detail

- Deferral Election Rules



- Commissions
 - Generally, a deferral election for “commission compensation” may be entered into before the end of the year preceding the year in which the customer makes payment to the service recipient for the goods or services for which the commissions are being paid.

Section 409A, In Detail

- Deferral Election Rules



- Final payroll period
 - Compensation payable after the end of the service recipient's tax year for service provided during the final payroll period of the tax year is treated as compensation for services performed in the year paid, unless the arrangement provides otherwise

Section 409A, In Detail

- Deferral Election Rules



- Recurring part-year compensation, e.g., teacher's compensation
 - Elections to receive compensation over a one-year period rather than the actual service period is not a deferral election.

Section 409A, In Detail

- Deferral Election Rules



- Cessation of deferrals upon unforeseeable emergency or 401(k) plan hardship or disability
 - A plan may provide that a service provider's deferrals will cease if the service provider has an unforeseeable emergency under the nonqualified plan, a hardship under a 401(k) plan or becomes disabled. In this case, the deferral election must be cancelled completely.

Section 409A, In Detail

- Payments on Separation Plan Service



- Access to plan benefits
 - Permissible Payment Events
 - Separation from service
 - Termination of employment – facts and circumstances test with 20% of average of prior 36 months of services safe harbor for employees and employees who switch to part-time status—may have a percentage of up to 50% based on facts and circumstances
 - May provide a different percentage in plan for phased retirement if done before elections are required
 - Employment relationship stays in tact while on bona fide leave for up to six months (29 months for disability); longer if right to return is provided by statute or contract

Section 409A, In Detail

- Payments on Separation Plan Service



- Identification of service recipient for terminations
 - Use a controlled group test but with a 50% ownership test
 - Plan may specify a percentage of 20% - 80% instead
 - In acquisition context seller and buyer may specify whether “same desk” rule applies for determining separation from service
 - Services as a director are not taken into account to determine whether an employee separates

Section 409A, In Detail

- Delay for Specified Employees

- For “specified employees” (top 50 officers by pay and 1% owners) of publicly-held companies distributions must be delayed for six months after separation from service (unless employee dies before six-month period has elapsed)
 - » Service recipient may designate an “identification date” for determining key employees. If a person is a key employee during the 12-month period ending on the identification date, he/she is treated as a “specified employee” beginning on the first day of the fourth (or earlier if specified in the Plan) month following the identification date
 - » Must use same identification date for all arrangements

Section 409A, In Detail

- Delay for Specified Employees



- May use a method that is over inclusive in identifying specified employees provided standard is objective and includes no more than 200 employees
- Use of an alternative list to delay a payment will not be treated as a change in time or form of payment

Section 409A, In Detail

- Payments on Disability

- Disability
 - Unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or last for a continuous period of not less than 12 months
 - Receiving income replacement benefits for not less than three months under employer plan by reason of any medically determinable physical or mental impairment that can be expected to result in death or last for a continuous period of not less than 12 months

Section 409A, In Detail

- Payments on Disability and Death

- deemed disability
 - » totally disabled by Social Security Administration
 - » disabled under disability insurance program (if program's definition of disability complies with one of the above definitions)
 - » disability may also give rise to a separation from service
- Death
 - Change in beneficiary will not be a change in time in form of payment even if a different life expectancy is used.

Section 409A, In Detail

- Payments on Specified Dates



- Date or schedule specified under plan
 - Objectively determinable amounts payable at a date or dates that are objectively determinable
 - The amount must be specifically identified or the amount must be determined pursuant to a non-discretionary formula
 - Tax gross-up payments satisfy fixed time and form of payment requirements if paid by the end of the service provider's taxable year following an audit
 - Payments can be based under some circumstances on the date payments are received by the service recipient

Section 409A, In Detail

- Payments for Unforeseeable Emergency

- Unforeseeable emergency
 - An unforeseeable emergency is a severe financial hardship resulting from extraordinary and unforeseeable circumstances arising out of events beyond the control of the service provider or beneficiary. (Similar definition as for 457(b) plans.)
 - Distribution must be limited to amount reasonably necessary to satisfy the emergency – availability of loans or distributions from qualified plans do not need to be taken into consideration

Section 409A, In Detail

- Payments on Change in Control



- Change in Control
 - Change in ownership
 - » Change of more than 50% of fair market value or voting power
 - Change in effective control
 - » Change of 30% or more of voting power; or
 - » Majority of Board members replaced in 12-month period
 - Change in ownership of assets
 - » Sale of at least 40% of fair market value of assets in a 12-month period

Section 409A, In Detail

- Alternative Payment Event

- A plan may provide for payment on earliest or latest of more than one permissible events
- A plan may provide that payment upon a permissible event (other than a specified date) may be made according to a fixed schedule determinable on the date of the event, provided the schedule is fixed at time the event is designated
- A plan may provide for an alternative payment schedule if a permissible event occurs on or before a specified date

Section 409A, In Detail

- Form of payment on separation from service may depend on
 - Whether the separation from service occurs during a limited period of time not to exceed two years following a change in control
 - Whether the separation from service occurs before or after a specified date or combination of date and period of service
 - Whether separation from service occurs for another reason

Section 409A, In Detail

- Payments on Specified Dates



- Designated Payment Dates
 - A payment is deemed to be made on a designated payment date if it is made by the end of the calendar year following or coincident with the date, or, if later, by the 15th day of the third calendar month following the date
 - A payment can also be made 30 days prior to a scheduled payment date provided the service provider cannot directly or indirectly designate the taxable year of the payment

Section 409A, In Detail

- Payments on Specified Dates

- Plan may provide that payment will be made within 90 days or less following a specified event (i.e. separation from service)
- Plan may provide that payment will be made in a specific taxable year of the service provider

Section 409A, In Detail

- Payment Delays

– Permissible delays in payment date

- Calculation of the amount is not possible due to events beyond the control of the service provider
- Service recipient cannot pay the funds without jeopardizing status as going concern
- Service recipient refuses to pay or inadvertently fails to pay provided service provider makes efforts to collect
- In the case of a change in control of the service recipient, payments to a service provider for stock, stock rights or amounts calculated by reference to stock may conform to payments to shareholders if paid within five years of change in control
- Agreement can also limit payments based on a formula or overall aggregate limit on payments

Section 409A, In Detail

- Payment Delays



- Service recipient reasonably anticipates deduction of payment would be limited or eliminated under Section 162(m)
- Service recipient reasonably anticipates payment would violate securities laws or other applicable law

Section 409A, In Detail

- Payment Elections

- When payment terms must be specified
 - Elective Plan – election regarding time and form of payment must be made at the time of the election to defer compensation
 - Non-elective Plan – the service recipient must specify the time and form of payment when the service provider first has a legally binding right to the payment. This designation is treated as an initial deferral election, so that the service provider can change the payment terms under the rules for “subsequent elections” described below

Section 409A, In Detail

- Payment Elections



- Separate distribution rules for earnings
 - A plan may specify that earnings credited on deferred amounts may be treated as separate from the amounts deferred
 - Should permit use of short-term deferral rule

Section 409A, In Detail

- Payment Elections



- Subsequent elections
 - A plan may permit a participant to change the time and method of payment. If so:
 - » The plan must require that the change not take effect for at least 12 months
 - » The plan must require that the payment commencement date be deferred for at least five years from the original payment commencement date (except for payments triggered by death, disability or an unforeseeable emergency)

Section 409A, In Detail

- Payment Elections

- In the case of payments due to commence on a specified date, the election must be made at least 12 months before that date
- “Payment”
 - » Entitlement to life annuity treated as a single payment
 - » Entitlement to installment payments treated as a single payment unless otherwise specified
- Change in longer to shorter payout period does not constitute an impermissible acceleration
- Election between alternative equivalent life annuity forms is not subsequent change—alternative annuities can contain a term certain feature, cash refund feature, Social Security leveling feature, cost of living features and subsidized j & s feature

Section 409A, In Detail

- Acceleration of Payments

- Prohibition on accelerations
 - Neither participants nor employers are permitted to accelerate distributions
 - Exceptions
 - Domestic relations orders
 - Conflicts of interest
 - FICA payments, and in the case of 457(f) plans income tax at vesting
 - Cash outs at termination of participation in arrangement of de minimis amounts 402(g) elective deferral limit
 - Amounts required to be included in income upon plan's failure to satisfy 409A

Section 409A, In Detail

- Acceleration of Payments

- Plan termination
 - » Within 12 months of dissolution of service recipient
 - » With 30 days before or 12 months after change in control
 - » At discretion of service recipient, if all payment made in window period more than 12 and less than 24 months of the termination and no new arrangement is adopted for three years
- In order to avoid a non-allocation year of service recipient's ESOP in following year
- Can amend plan to provide for acceleration of a payment in the event of death, disability or an unforeseeable emergency

Section 409A, In Detail

- Penalties

- What are the consequences of failure to comply with Section 409A?
 - If at any time during a taxable year a plan fails to comply with Section 409A, then for each participant for whom the failure relates:
 - All compensation deferred for that taxable year and all preceding taxable years is included in gross income to the extent not subject to a substantial risk of forfeiture
 - The tax imposed is increased by the sum of:
 - » 20% of the amount required to be included in gross income, plus
 - » Interest at the underpayment rate plus 1% on the underpayments that would have occurred if previously included in income (when originally deferred or vested, if later)
 - Some aggregation of plans may be required for a participant

Section 409A, In Detail

- Reporting



- What are Section 409A's new reporting requirements?
 - Section 409A requires annual reporting to the IRS of amounts deferred
 - Report current year deferrals to a Code Section 409A nonqualified deferred compensation plan under Code Y
 - Report any earnings earned during the year on current and prior deferrals
 - Report any amounts includable in income because of a violation of Code Section 409A under Code Z
 - These amounts should also be included in Box 1
 - Exception for de minimis amounts (currently \$600) and amounts that accrues under a defined benefit arrangement if not reasonably ascertainable

Section 409A, In Detail

- Effective Dates



– Section 409A effective date

- Section 409A applies to amounts deferred on or after 2004 and to amounts previously deferred that vest on or after 2004
- Section 409A also applies to amounts deferred before January 1, 2005, if the plan is “materially modified” after October 3, 2004
 - A plan is considered “materially modified” if a benefit right existing as of October 3, 2004 is enhanced or a new benefit is added, even if the enhancement would be permitted under 409A

Section 409A, In Detail

- Effective Dates

- Amounts deferred and vested prior to 2005, and the income on those amounts (“old money”) are grandfathered
 - Care must be taken not to cause a “material modification” to the grandfathered amounts
 - Not a modification to add payments for domestic orders
 - If materially modified plan complies with 409A the modification itself will not result in a violation

Section 409A, In Detail

- Transition Rules



- Section 409A’s transition rules
 - During 2005 - 2007 plans and plan participants had/have a limited opportunity to make changes without violating 409A. Changes include:
 - Terminating deferrals made through 12/31/05, in whole or part, and cashing out in a lump sum – must be completed by 12/31/2005
 - Canceling noncompliant stock options and SARs and reissuing compliant stock options and SARs in their place – must be completed by 12/31/07
 - Allowing participants to make new payments elections with respect to previously deferred amounts that are subject to 409A - must be completed by 12/31/07

Section 409A, In Detail

- Transition Rules

- Final regulation transition rules
 - Plans subject to 409A that have not distributed all benefits by the end of 2007 will need to be amended to comply with the final regulations by 12/31/07
 - Plans that have distributed all benefits by the end of 2007 do not need to be amended but must be able to demonstrate good faith compliance
 - **Any** extension of a stock option or SAR before 4/10/07 that otherwise complies with 409A will be permitted
 - Deferral elections made before 1/1/08 that are consistent with the guidance in effect before the final regulations can continue in place

Section 409A, In Detail

- Transition Rules

- Deferral elections not yet made that would have been proper under the performance-based compensation exception prior to the final regulations can continue to be made through 2008
- Where payments have begun based on a good faith interpretation of the guidance in effect prior to the final regulations, but under the final regulations should not have begun, payment can either continue to be made or the payment method can be changed under the transition rules to delay payment.
- If payments should have begun under the standards in the final regulations regarding separation from service, however, payment must commence.

What Should Employers Do Now?

- Inventory all plans that are not specifically excepted from 409A to see which ones have deferral elements (don't forget severance plans and employment agreements with severance benefits)
- Consider whether plans subject to 409A should take advantage of a transition rule, particularly the rule which expires the end of this year allowing changes to payment methods, and if so, consult with counsel to assist in implementation