

## **CODE SECTION 409A CREATES NEW RULES FOR DEFERRED COMPENSATION ARRANGEMENTS**

Section 409A was added to the Code and is generally effective with respect to all subject deferrals that vest on or after January 1, 2005. All covered deferred compensation arrangements must be amended by December 31, 2006. Relevant transition rules allow covered plans to operate in the meantime so long as they are operated in compliance with Section 409A or a good faith interpretation of IRS authority issued pursuant thereto, which includes proposed regulations issued by the IRS on September 29, 2005. Benefits that are fully vested under existing plans as of December 31, 2004 are “grandfathered” under old law, but only if the existing plan is not “materially modified” after October 3, 2004.

Because of the broad sweep of Section 409A, **almost every arrangement that provides employee compensation payable in a form other than basic salary should be reviewed for compliance purposes.** Failure of a covered arrangement to comply with the new rules will cause affected employees to be taxed when deferred compensation benefits vest, even if actual payment of benefits does not occur until years later. Vesting for this purpose occurs when benefits are no longer subject to a “substantial risk of forfeiture.” A substantial risk of forfeiture exists if receipt of benefits is conditioned on the performance of substantial future services by the participant. Adherence to any non-compete provisions is not considered to present a substantial risk of forfeiture. Further, there is an additional twenty percent (20%) penalty tax on affected employees. Consequently, employees in the thirty-five percent (35%) tax bracket would be taxed at an aggregate rate of fifty-five percent (55%) upon vesting of non-compliant deferred compensation benefits.

### **Covered Arrangements**

Section 409A applies to all “nonqualified deferred compensation plans,” which term includes any arrangement that provides a “service provider” (employee or independent contractor) a legally binding right to compensation that is not currently received (either actually or constructively) but is paid in a later taxable year. A legally binding right may exist even when the future benefit payment is conditioned on services to be rendered by the participant pursuant to applicable vesting provisions.

The definition of “nonqualified deferred compensation plans” extends to both elective and non-elective arrangements, including **individual employment and consulting agreements** that defer receipt of any portion of earned income. An employer-employee relationship is not required as Section 409A applies to otherwise covered arrangements that benefit directors and independent contractors.

Expressly excluded from this definition are qualified retirement plans under Section 401(a) of the Code (this category includes pension plans, profit sharing plans and Section 401(k) plans), SEPs and SIMPLE plans, Section 403(b) and Section 457(b) plans for employees of tax-exempt organizations, as well as vacation, sick leave, compensatory time, disability pay and death benefit plans. Common stock option plans having an exercise price not less than the fair market value of the underlying stock at the time of grant are also excluded from the definition

along with plans providing stock appreciation rights so long as those plans do not pay benefits based on dividends between the date of grant and the date of exercise. Guidance as to equity compensation plans of partnerships and limited liability companies is forthcoming.

There is a limited exception for severance pay plans that meet certain requirements, including a limit on the aggregate amount of severance payments to the lesser of (1) two times the statutory limit on annual compensation for qualified plan purposes (the statutory limit is \$220,000 in 2006) or (2) two times the employee's compensation in the calendar year prior to termination of employment. Further, all payments must be made only on account of an *involuntary* termination of employment and must be completed no later than the end of the second calendar year following the year in which termination occurs. However, broad-based severance pay plans that provide the employer a unilateral right to reduce or eliminate benefits at any time may defer income until termination of employment notwithstanding Section 409A.

There also is an exception for arrangements providing "short-term deferrals" of income. Such arrangements that provide for the payment of benefits within 2½ months of the end of the taxable year in which benefits are no longer subject to a substantial risk of forfeiture are exempt from Section 409A, even if the benefits cover several years of services. This exception is illustrated by an example of a bonus arrangement that is *not* subject to Section 409A from the preamble to IRS Notice 2005-1:

For example, a three-year bonus program requiring the performance of services over three years and entitling the service provider [employee] to a payment within a short specified period [2½ months] following the end of the third year generally would not constitute a deferral of compensation.

Similarly, annual discretionary bonus arrangements which are paid to an employee or independent contractor within 2½ months following the end of the year are exempt from Section 409A.

Employers may also negotiate good faith severance agreements with employees at the time of termination of employment, and such agreements may provide for deferred payments determined at that time.

Bearing in mind that many employment agreements provide severance payments following termination of employment, it follows that **employers will need to review their employment agreements, bonus arrangements, equity incentive plans, severance pay plans, split-dollar life insurance arrangements and any post-retirement consulting agreements in addition to all traditional deferred compensation plans** (nonqualified elective salary and bonus deferral arrangements, supplemental executive retirement plans ("SERPs"), and excess benefit plans) for compliance with Section 409A.

### **Substantive Requirements**

Covered deferred compensation arrangements will have to be retroactively amended to reflect the following requirements and will have to be operated in accordance with these requirements until such amendment:

- For arrangements that allow participants to choose to defer a portion of current compensation (“elective plans”), participants generally must make an irrevocable election to defer compensation before the services generating the compensation are performed (limited exceptions apply for initial eligibility, when the new participant has a thirty (30) day period to make the initial deferral election, and performance based compensation governed by pre-established individual and/or entity performance criteria). Such elections also must specify the form of payment (typically lump sum or installment) and designate one or more of the permitted distribution triggers for benefit payment.
- Non-elective plans also must designate in advance the form of payment of benefits and a future distribution time or permitted event for benefit payment. The permitted distribution triggers are **separation from service, death, disability, a specified time** (such as attainment of a specified age), **an employer’s change in control, and an unforeseeable emergency**. Note that a specified time does not include events over which an employee may have some control, such as when a child begins college or when the employee elects a retirement plan distribution. There are very specific definitions for each of these terms provided in the 2005 proposed regulations. For example, the definition of “disability” requires, in effect, complete and total disability, and the common practice of linking a deferred compensation distribution to the definition of disability included in the employer’s group disability plan may not be permissible, depending on the disability plan’s definition. In other words, a liberal definition of “disability” contained in an employer’s group disability plan cannot be used to avoid the intended statutory limitation on distributions.
- With limited exceptions, covered arrangements cannot permit the acceleration of benefits (this eliminates the so-called “haircut” provisions permitting employees to elect an early distribution of benefits at any time the employee is willing to forfeit a portion of that benefit). Permitted exceptions include the acceleration of benefits in the case of qualified domestic relations orders, the cash-out of benefits not in excess of \$10,000, and cash distributions to participants in Section 457(f) plans for the payment of income taxes due on the vesting of benefits.
- Subsequent participant elections to defer the receipt of benefits are permitted, but only if the election is made at least twelve (12) months in advance of the scheduled payment and the election defers the payment at least five (5) years from the original payment date (except in the case of death, disability and unforeseeable emergency). The proposed regulations permit employers to defer payments in order to comply with the securities law or loan covenants in financing agreements, or to preserve the deductibility of compensation paid to a participant under Section 162(m) of the Code, which provides a \$1 million annual limit on deductible compensation. Also note that there is a mandatory six-month postponement of the payment of benefits that applies to “key employees” of publicly-traded companies.

- Plan or trust provisions that require an employer to set aside assets to secure benefit payments in the event there is an adverse development in the employer's financial health will trigger immediate taxation to affected employees.
- Generally, payment of deferred compensation benefits cannot be accelerated by termination of the deferred compensation arrangement. However, the 2005 proposed regulations do permit termination distributions in any of the following circumstances: (1) the plan termination takes place within twelve (12) months of a change in control; (2) all plans of the same "type" are terminated, all benefit payments are made within twenty-four (24) months of such termination(s) and no new deferral arrangements are adopted for five (5) years; and (3) the termination occurs on corporate dissolution or with approval of a bankruptcy court.
- Employment agreements, consulting agreements and other arrangements for payment of compensation to former employees cannot be used to circumvent the restrictions of Code Section 409A. Accordingly, where an employee enters into an agreement with the employer providing for future payments in consideration of the employee merely being available to perform services if requested to do so, and the parties do not intend that the employee provide more than "insignificant services," the employee may (depending on the surrounding facts and circumstances) be treated as having terminated employment for purposes of Section 409A. A safe harbor provision recognizes the validity of such an agreement if the employee provides services at an "annual rate equal to at least 20 percent of the services rendered and the annual remuneration for such services is equal to at least 20 percent of the average remuneration earned during the immediately preceding three full calendar years of employment. . .".
- Overseas "rabbi trusts" used to secure payment of deferred compensation benefits with assets not located in the United States will trigger taxation to affected participants. Domestic rabbi trusts are not impacted by Section 409A.

### **Recommendations**

Section 409A compliance requires the review of existing employment and post-retirement consulting agreements, bonus arrangements, equity incentive plans and severance pay plans as well as traditional deferred compensation plans to establish whether or not those agreements are subject to Section 409A. Arrangements in existence as of October 3, 2004 need to be examined to determine if they provide for the accrual and vesting of benefits by December 31, 2004, and if they have been "materially modified" since October 3, 2004. If so, amendments reflecting the requirements of Section 409A will be required. For this purpose (and in view of the required operation of all covered deferred compensation arrangements in compliance with Section 409A or a good-faith interpretation of the regulations thereunder), it makes sense to review those covered arrangements providing for the vesting or payment of benefits in early 2006 first so that only benefit vesting and payment in compliance with Section 409A will in fact occur.

Bear in mind that the 2005 proposed regulations reflected above are not effective until January 1, 2007, and they are subject to modification until that time. It is reasonable to expect that existing authority under Section 409A (which includes IRS Notice 2005-1 as well as the 2005 proposed regulations) will be fleshed out in a number of respects before the end of this year. Such modification could, of course, affect the substance of this article.

Although the above general information about Code Section 409A can serve as an important starting point for employer consideration of its Section 409A compliance, this information cannot be relied upon as legal advice. For consideration of your specific compliance concerns, please discuss your individual situation with competent legal counsel.

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Andrew S. Williams  
Aronberg Goldgehn Davis & Garmisa  
One IBM Plaza, Suite 3000  
Chicago, Illinois 60611  
312/755-3145  
[awilliams@agdglaw.com](mailto:awilliams@agdglaw.com)