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This article highlights ten key items that should be considered in drafting or amending plans and other agreements in light of the complex rules under tax code Section 409A that apply to most nonqualified deferred compensation arrangements. The authors divide these ''traps for the unwary'' into two broad categories: problems that arise in distinguishing what is and what is not deferred compensation subject to Section 409A and problems that arise in documenting compliance with Section 409A.

Internal Revenue Code Section 409A: Ten Traps for the Unwary

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Section 409A of the Internal Revenue Code imposes complex new requirements on deferred compensation arrangements that must be satisfied in order to avoid accelerated income inclusion, a 20 percent additional income tax, and a further additional income tax calculated as interest on income taxes deferred under the arrangement. The financial consequences of violating Section 409A are potentially devastating for the affected employee or other service provider. Moreover, Section 409A can be surprisingly broad in its application. With limited exceptions, it applies to any and all legally binding rights to compensation in a future taxable year that arise out of a service relationship. Accordingly, Section 409A has implications for most forms of equity and cash compensation including bonus plans, long-term incentives, equity compensation arrangements, elective deferrals, supplemental retirement arrangements, and employment agreements and severance promises.

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Final regulations issued in April 2007 weighed in at 397 pages (including the lengthy preamble) and provide many detailed, complex rules. Pursuant to IRS Notice 2007-86,[1] issued on Oct. 22, 2007, the final regulations generally become effective on Jan. 1, 2009. Until that time, taxpayers generally must administer plans in accordance with applicable IRS guidance (in particular, Notice 2005-1[2]) or, to the extent an issue is not addressed in such guidance, with a reasonable, good faith application of the statute.

[1] 2007-46 I.R.B. 990.
[2] 2005-1 C.B. 274.

In this article, we attempt to briefly highlight 10 traps for the unwary. In light of the complexity of the rules and the adverse consequences of noncompliance for employees and other service providers, employers and other service recipients need to carefully review all of their compensation arrangements to ensure that the rules under Section 409A are properly documented and are followed in operation.

Background.

Section 409A principally regulates timing with respect to nonqualified deferred compensation — timing in regard to elections to defer payment or to set the terms for deferred payments and permissible timing for payments of deferred compensation. Adopted into law in the wake of Enron and other corporate scandals, the goal of the provision was to introduce new rigidity into the rules governing deferred compensation, and particularly to restrict access to deferred amounts until they are due and payable. The statute became effective on Jan. 1, 2005, and since that time, good faith compliance with the statute generally has been required. The IRS has provided a series of guidance items providing transition relief, culminating in Notice 2007-86 and recent limited correction relief under Notice 2007-100.[3]

Except as otherwise provided in regulations, Section 409A generally requires elections to defer compensation to be made in the year prior to the year in which services relating to the compensation will first be rendered.[4] The time for ultimate payment of deferred amounts generally must be specified by the deadline for making the election to defer. Permissible payment times are limited to a fixed time or schedule or the following specified events: separation from service, death, disability, unforeseeable emergency, or change in control.[5] Key employees of publicly traded companies are subject to the additional requirement that payments of deferred compensation triggered by a separation from service be delayed by six months from the date of separation. Once amounts are deferred, accelerated payment is severely restricted. And, all of this is enforced with a formidable compliance incentive, which punishes failure to comply with automatic inclusion of all amounts deferred under plans of the same type and subjects those included amounts to the additional 20 percent tax plus an interest charge. Congress did not intend to encourage deferrals of compensation with the addition of Section 409A, but rather attempted to limit deferrals by subjecting them to much more stringent regulation than under prior rules.

Still, there are many compelling business reasons for promising to pay compensation later, and so deferred compensation is a fact of business life. Compliance with Section 409A has become a fact of business life as well. Currently, taxpayers continue to benefit from the generous but necessary transition relief provided by Treasury and the IRS, set to expire after Dec. 31, 2008. Thereafter, the full weight of the detail and complexity of the final Section 409A regulations will be brought to bear. In the meantime, taxpayers and tax practitioners benefit from another year with the protection of generous transition relief, and there is a continuing opportunity to better understand and plan for the complexities of Section 409A. While many of these complexities do arise in connection with certain operational compliance requirements for timely elections and payments, the areas where taxpayers and practitioners seem to struggle the most is with respect to defining what is, and what is not, deferred compensation, and then effectively delineating between the two. The rules governing these two categories are very different and subjecting more compensation to Section 409A than absolutely necessary is undesirable due to the downsides if Section 409A applies and is violated.

In recognition of the fact that not every promise to pay compensation in the future is deferred compensation that should be subject to the Section 409A restrictions, IRS guidance, beginning with Notice 2005-1 and culminating in the final regulations, includes a number of important exceptions, certain of which are prominently featured in our list. Perhaps the most important of these is the ''short-term deferral'' exception.[6] Sometimes called the ''vest and pay'' exception, this is an exception to the general rule that any promise to pay compensation in a future taxable year is deferred compensation subject to Section 409A.[7] Under this exception, where promised amounts are subject to a substantial risk of forfeiture (i.e., a requirement to perform substantial services or the attainment of an individual or corporate performance goal, the attainment of which is substantially in doubt) and the amounts are to be paid no later than the 15th day of the third month following the taxable year in which the substantial risk of forfeiture lapses, then the amounts are not treated as deferred compensation subject to Section 409A. In plain English, the idea here is that if amounts are earned and paid on a more or less simultaneous basis, then the underlying promise is not one that provides for deferral of compensation. Two of the items on our list deal with some of the pitfalls of complex applications of the short-term deferral rule.

There also is an exception under the final regulations for certain amounts of involuntary separation pay. Under this exception, if amounts are payable solely on account of involuntary separation from service or pursuant to a window program, then to the extent that such amounts are no more than two times the individual's annual pay (capped at $230,000 for 2008) and such amounts are payable no later than the end of the second year following the year of termination, then the amounts are not subject to Section 409A.[8] Sometimes called the ''two years/two times pay'' exclusion, this provision keeps most rank-and-file severance programs from being subject to Section 409A. It is equally applicable to top executives, though, and sometimes the application of the exception in those cases can get complicated. Several of the items on our list address those complications.

It is worth noting that not only is involuntary termination an important concept for the involuntary separation pay exception, it can also constitute a substantial

[3] 2007-52 I.R.B. 1243.

[4] I.R.C. § 409A(a)(4)(B)(i).

[5] I.R.C. § 409A(a)(2)(A).

[6] Treas. Reg. § 1.409A-1(b)(4).

[7] There are statutory exceptions, of course, for tax-qualified retirement plans, excludible health benefits, vacation, sick and compensatory time arrangements, and disability and death benefit plans. There are a number of other exceptions provided by the regulations, as well, but the basic definition of deferred compensation (from which the exceptions are subtracted) is very broad.

[8] Treas. Reg. § 1.409A-1(b)(9)(iii).

risk of forfeiture condition for purposes of the short-term deferral exception. In that case, the short-term deferral exception and the involuntary separation pay exclusion can be applied in tandem. We address certain of these issues as well. For purposes of Section 409A, involuntary termination (or separation) can include termination for ''good reason.''[9] In this regard, good reason termination can be thought of as a proxy (of sorts) for constructive termination, in the sense that the key element is that the employer takes clear action indicating a loss of esteem for the affected employee. Our list addresses some of the nuances in adapting to the approach adopted in the final Section 409A regulations.

The final regulations also include fairly broad exclusions for at-the-money stock options and stock appreciation rights (SARs).[10] Although these exceptions will cover the great majority of ''plain vanilla'' stock options and SARs, there are detailed rules for permissible stock that can underlie such excludible options and rights (generally common stock, with no dividend preferences, issued by the direct service recipient company or a parent company). If these detailed rules are not satisfied, most such awards will violate Section 409A. There is a separate exclusion for incentive stock options (ISOs) under Section 422 and qualifying employee stock purchase plans (ESPPs) under Section 423 that is in some ways broader than the general exclusion for at-the-money options and SARs. Shifting between these exclusion categories can be problematic, though, as we discuss further below.

Finally, our list addresses some essential items to consider as plans and arrangements are structured and drafted to meet the Dec. 31, 2008, deadline. From preserving the exemption for Section 409A for ''grandfathered'' amounts to adopting the best method for identifying ''specified employees'' subject to the special six-month delay required for payments of deferred compensation by public companies on account of separation from service, there is no shortage of items to consider. Most of these items require decisions by Dec. 31, 2008, and will be difficult to change thereafter.

The Traps.

The ten items we have chosen to highlight in this article fall into two basic categories, although some of the items straddle both categories. Essentially, these categories are issues of distinguishing amounts subject to Section 409A from amounts excluded from Section 409A requirements and of proper documentation for Section 409A compliance.

I. Alternative Rights to the Same Funds.

Many of the rules under Section 409A depend on the type of payment involved. For example, payments that are made solely in connection with an involuntary termination of employment may be excludible from Section 409A under the short-term deferral rule or the limited exclusion for involuntary separation pay. In applying these exclusions, however, it is critical that the payments in question are payable solely in that event. For example, if the same payment could be made in alternative circumstances — for example, upon a change in control or after meeting a minimum service requirement — the exclusion will not apply.[11]

II. Incentive Stock Options.

As noted above, the final regulations provide an exclusion from Section 409A restrictions for ISOs under Section 422. An ISO is excluded from coverage under Section 409A even if it does not otherwise satisfy the rules for the general Section 409A exclusion for at-the-money stock options and SARs.[12] For example, ISOs can be granted with respect to preferred stock, which cannot qualify as service recipient stock (and, thus, generally will not be excluded from Section 409A coverage absent the separate Section 409A exclusion for ISOs).

The critical trap with ISOs is that if options intended to be ISOs do not satisfy the general rules for Section 409A exclusion, and are excluded from coverage solely because they are ISOs, it is absolutely critical that they meet the requirements for ISO status as of the date of grant (e.g., fair market value exercise price) and that they not lose ISO status. This can happen, for example, if the ISO is modified or extended, or even if, due to an acceleration of vesting, the $100,000 per year ''first exercisable'' ceiling is breached. This last item is a real pitfall for unvested ISOs that accelerate vesting upon a change in control or in other events (e.g., termination without cause). If ISO status is lost and the general 409A exclusion is unavailable, the purported ISOs generally will be covered by Section 409A, and typically will violate Section 409A — a potentially nasty surprise.

III. ''Replacing'' Arrangements Subject to Section 409A.

If it were permissible to replace one arrangement subject to Section 409A with another arrangement and thereby change the payment schedule, it would present an easy opportunity to change payment timing in a way that would not be permitted under the original arrangement. To address this issue, the final regulations provide that any amount, or entitlement to any amount, that acts as a substitute for, or replacement of, amounts deferred under a nonqualified deferred compensation plan constitutes a payment of deferred compensation or deferral of compensation under the separate nonqualified deferred compensation plan.[13] For example, an agreement that is subject to Section 409A generally cannot be replaced by a substitute agreement that is nominally subject to the short-term deferral rule. Such an arrangement would continue to be subject to Section 409A. Employers and other service recipients need to keep this rule in mind whenever a new arrangement is designed to replace another.

This issue very commonly arises in negotiated separations from service. Historically, an employer and employee have felt relatively free to restructure deferred payments or settle disputed amounts in the context of a negotiated separation. The dual prohibitions under Section 409A against acceleration generally and substitutions specifically represent a radical change to what is possible in the context of negotiated separations. Taxpayers and their advisers need to tread carefully in this area to avoid crippling mistakes.

[9] Treas. Reg. § 1.409A-1(n)(2).
[10] Treas. Reg. § 1.409A-1(b)(5)(i).
[11] Treas. Reg. § 1.409A-1(b)(9)(iii).
[12] Treas. Reg. § 1.409A-1(b)(5)(ii).
[13] Treas. Reg. § 1.409A-3(f).

IV. Changing "Good Reason" Definitions.

Employment and severance agreements often include "good reason" or "constructive termination" provisions, pursuant to which an employee may voluntarily terminate and receive severance in specified circumstances (e.g., demotion or forced relocation). The treatment of such provisions was not addressed in the proposed regulations, but the final regulations provide detailed rules regarding the terms under which a good reason termination may be treated as an involuntary termination for purposes of the short-term deferral and involuntary separation pay exclusions from the Section 409A restrictions. One of the key advantages of these two exclusions in the severance context is that they eliminate or reduce the impact of the six-month delay requirement for payments of deferred compensation to a key employee of a public company, because amounts exempt from the Section 409A restrictions are similarly exempt from the six-month delay requirement.

An issue that arises frequently is the ability to modify pre-existing good reason termination provisions to bring them into line with the requirements of the final Section 409A regulations. The IRS addressed this issue in some detail in Notice 2007-78,[14] and the rules can be summarized as follows:

■ If an existing good reason provision currently constitutes a substantial risk of forfeiture (SROF), it generally can be changed in 2008 to another good reason definition that also is a SROF (e.g., to the "safe harbor" good reason definition in the final regulations). This can allow continued reliance on the short-term deferral exclusion if it is otherwise available (e.g., if the severance is paid in a lump sum shortly following termination of employment). Whether a good reason provision constitutes a SROF is determined under all the facts and circumstances. Although not explicitly addressed by Notice 2007-78, it presumably should be possible to treat a "double trigger" good reason severance provision (which generally triggers severance only upon a qualifying termination after a change in control) as subject to a SROF if a change in control has not yet occurred and does not occur in the year the definition is changed.

■ If the good reason provision is not a SROF because it is so broad that the severance rights effectively are considered "vested" by the IRS, it generally cannot be modified to make it a SROF unless the more stringent conditions are also supported by material additional consideration satisfying the requirements of the final regulations.

■ However, a good reason provision that is not a SROF apparently can, without material additional consideration, be modified to be the equivalent of an involuntary termination provision for purposes of the "two times/two years" involuntary separation pay exclusion.

V. Keeping in Mind Limitations on the Short-Term Deferral Rule

If the short-term deferral rule is satisfied, the payments are not subject to Section 409A. In order for the rule to apply, the arrangement must require, by its terms, that the payment be made within the short-term deferral period (i.e., generally within 2-1/2 months after the end of the taxable year in which a substantial risk of forfeiture of the right lapses). If the payment is conditioned upon an event that could cause the amount not to be made during this timeframe, Section 409A generally applies to the payment. In other words, even if a payment happens to be made during the short-term deferral period, it does not qualify for the exception if under the legally binding right the amount could have been paid after the short-term deferral period.[15] For example, if promised compensation was subject to a three-year service requirement for vesting (i.e., a SROF) and was payable upon separation from service, it would not be a short-term deferral if the individual happened to terminate and trigger payment one month after vesting. Because the amount was payable upon separation from service, and that event is uncertain and could have happened after the short-term deferral period, the amount in question is treated as deferred compensation and is not excluded as a short-term deferral.

The final regulations provide that installment payment streams may be bifurcated for purposes of the short-term deferral rule, but only if each payment in the payment stream is designated (in writing and in accordance with the Section 409A timing requirements) as a separate payment for purposes of the Section 409A election rules. This designation should be made in writing and in accordance with the Section 409A timing requirements. This designation can be added under the transition relief through the end of 2008 but otherwise should generally be included from the very beginning under any arrangement for which this treatment is desired. For example, where a stream of payments is payable only upon involuntary termination (i.e., the lapse of a SROF) and the payments have been properly designated as separate payments, those payments that are payable within the short-term deferral period may be excluded under the short-term deferral rule and only those payments beyond that period will be treated as deferred compensation subject to Section 409A (although the involuntary separation pay exclusion may apply to some or all of those later payments). In order to comply with this rule, plan documents should be reviewed and, if desired, revised to include the separate payment designation by the end of 2008.

VI. Documenting Reimbursement and In-Kind Benefits.

Section 409A potentially applies to any taxable payment made in a year following the year in which the legally binding right to receive the payment arises. It is not limited to cash payments, but can include in-kind benefits and other transfers of value. The final regulations provide guidance on structuring taxable reimbursements or in-kind benefits to comply with Section 409A.[16] Certain benefits are excludable from Section 409A restrictions entirely (e.g., certain taxable post-termination health benefits). Other benefits are deemed to comply with Section 409A if specified requirements are met. In particular, a reimbursement plan must provide in writing for the reimbursement of expenses incurred during an objectively prescribed period and, importantly, the amount of reimbursable expenses incurred or in-kind benefits available in one taxable year cannot affect the amount of reimbursable expenses or in-kind benefits available in a different taxable year. In

[14] 2007-41 I.R.B. 780.

[15] Treas. Reg. § 1.409A-1(b)(4)(i)(D).

[16] Treas. Reg. § 1.409A-1(b)(9)(v).

addition, the reimbursement arrangement must specify that payment must be made by no later than the end of the service provider's taxable year following the taxable year in which the expense is incurred. Such reimbursement or in-kind benefit rights may not be subject to liquidation or exchange for another benefit.

Employers need to review their documentation of these types of benefits for compliance with Section 409A. These types of promises can be buried in various places, including executive employment agreements, severance plans, separate plan documents, etc. A failure to timely amend can result in a Section 409A violation.

VII. Changing Payment Elections Under the Transition Rules.

Notice 2007-86 extended the payment election transition rule provided in Notice 2006-79. Under the new Notice, with respect to deferrals subject to Section 409A, a plan may provide, or be amended to provide, for new payment elections on or before Dec. 31, 2008, with respect to both the time and form of payment. Such an election may also apply to amounts that are short-term deferrals as long as the election is made before the year in which the amount otherwise would have been paid (and, in all events, no later than Dec. 31, 2008). However, election changes cannot be made in 2008 to defer payments that otherwise would be made in 2008 or to accelerate payments into 2008.

Care must be taken to ensure that a transition election does not inadvertently cause a violation. The risk for inadvertent violations is greatest where the election will change the time for a payment previously payable upon the occurrence of an uncertain event, such as separation from service. In such a case, if a service provider attempts to elect during 2008 to change from payment upon separation from service to five years after the date of termination/separation, but separation occurs in 2008, the original election must be honored. A straightforward way to deal with this problem from a drafting perspective would be to delay the effective date of the change until January 1 of the year following the election, with the pre-existing election to remain in force until that time.

VIII. Preserving Rights to Grandfathered Amounts.

Deferred compensation that was ''earned and vested'' as of Dec. 31, 2004, is exempt from Section 409A coverage as long as there is no material modification after Dec. 31, 2004.[17] This means that pre-2005 amounts generally can be administered in accordance with their terms even if such terms are no longer permitted under Section 409A (e.g., ''haircut'' provisions that permit in-service distributions at any time if the participant forfeits 10 percent of his or her benefit). Care should be taken to avoid losing grandfathered status where the intent is to preserve it. The boundaries of what constitutes a ''material'' modification are not entirely clear, so employers may want to tread carefully and avoid making any changes that impact grandfathered benefits. For example, plans often pay out all benefits upon a change in control. Section 409A includes a specific definition that must be used for such amounts subject to Section 409A. If the plan had a change in control cashout provision in effect on Dec. 31, 2004, and there is a desire to use a single definition for all amounts in order to simplify plan administration, whether changing from the old definition to the 409A-compliant definition constitutes a material modification will need to be considered.

[17] Treas. Reg. § 1.409A-6(a).

IX. Designating Time and Form of Payment of Deferred Compensation.

Section 409A generally provides that deferred compensation may only be paid out in specified circumstances, such as separation from service, disability, change in control, etc. Any arrangement subject to Section 409A generally needs to have ''hard-wired'' payment events that satisfy Section 409A, without any discretion on either the service provider's or the service recipient's part to make any changes (subject to some limited exceptions). Agreements should be carefully reviewed for compliance with this rule. For example, it is not uncommon for employment agreements to include severance provisions that permit the employee to elect either a lump sum or installment payments at the time of termination of employment, and such discretion generally must be eliminated.

X. Specified Employees — Consistency in Definition.

Section 409A generally requires that any distribution to a ''specified employee'' in connection with the employee's separation from service (i.e., termination of employment) must be delayed until six months after the separation.[18] Specified employees are defined in Section 416(i) of the tax code and generally include the ''top 50'' officers of publicly traded companies and their controlled group (i.e., generally including 80-percent-related affiliates), as well as certain employee-shareholders of publicly traded companies. The specified employee rules do not apply to companies that are not publicly traded as of the date of an employee's separation from service. The final regulations provide default rules for determining the specified employee group as well as various alternative definitions that may be chosen by the employer.

The specified employee rules include at least two potential traps. First, any arrangement that covers a specified employee and potentially includes payment upon a separation from service must explicitly incorporate the six-month delay.[19] Second, the final regulations require that all members of a controlled group must use the same definition of specified employee.[20] This may be quite tricky, particularly for conglomerates with affiliates in different lines of business that rarely communicate with each other. In order to address the difficulties with applying this rule, large companies with many affiliates may want to simply apply a six-month delay to all distributions upon employees' separations from service. Although this will result in delayed distributions for some nonspecified employees, it avoids the risk of inconsistent definitions within the controlled group and Section 409A violations.

[18] I.R.C. § 409A(a)(2)(B)(i).
[19] Treas. Reg. § 1.409A-1(c)(3)(v).
[20] Treas. Reg. § 1.409A-1(i).

Conclusion.

These are just a few of the key traps for the unwary. As a general rule, any time a compensation arrangement is to be put in place, modified, or terminated, it should be carefully vetted for potential Section 409A issues.

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