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Changes to Nonqualified Deferred Compensation Rules  
Applicable to Tax-Exempt Employers

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## **CHANGES TO DEFERRED COMPENSATION RULES APPLICABLE TO TAX-EXEMPT EMPLOYERS**

### **I. OVERVIEW: NEW § 409A IMPACTS NONQUALIFIED DEFERRED COMPENSATION**

In 2004, the Internal Revenue Code (“Code”) saw the addition of new § 409A, which governs nonqualified deferred compensation plans. Effective 2005, failure to comply with this provision will result in the amount sought to be deferred being subject to current taxation, and possibly a penalty and interest. As of January 1, 2005, plans were required to operate in good-faith compliance with Code § 409A; by December 31, 2006, plans must also be amended for documentary compliance with Code § 409A.<sup>1</sup>

Generally, Code § 409A should present few compliance issues for tax-exempt employers using typical nonqualified deferred compensation arrangements.<sup>2</sup> More sophisticated arrangements, however, such as those using a rolling risk of forfeiture, a non-compete agreement, or a post-employment consulting arrangement will require further review and likely changes to comply with Code § 409A.

To aid practitioners, employers, and employees in understanding the mechanics of Code § 409A, Treasury and the Internal Revenue Service (“IRS”) have released several pieces of interpretive guidance. On December 20, 2004, Notice 2005-1 was released<sup>3</sup> and on September 29, 2005, proposed regulations were released.<sup>4</sup> Until final regulations are released, employers may follow rules under Notice 2005-1, the proposed regulations, or both.<sup>5</sup> On December 8, 2005, the IRS also issued Notice 2005-94, which suspended for 2005 certain new reporting and withholding obligations of employers under Code § 409A.<sup>6</sup>

#### **A. Plans Subject to Code § 409A**

##### *1. Traditional Retirement Vehicles and Eligible Deferred Compensation Plans Not Subject to Code § 409A*

Code § 409A does not apply to traditional retirement vehicles, typically thought of as qualified plans under Code § 401(a); cash or deferred arrangements under Code § 401(k); and tax-sheltered annuities, custodial accounts, or retirement income accounts under Code § 403(b).<sup>7</sup> Nor does Code § 409A apply to eligible deferred compensation plans established pursuant to Code § 457(b).<sup>8</sup>

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<sup>1</sup> 70 Fed. Reg. 57,954 (Oct. 4, 2005).

<sup>2</sup> Code § 409A applies to nonqualified deferred compensation paid to employees and independent contractors (collectively, “service providers”). For simplification, we refer only to employees, but unless it is clear that another meaning was intended, our use of “employee” also includes “independent contractors.”

<sup>3</sup> Notice 2005-1, 2005-2 I.R.B. 274 (published as modified on Jan. 6, 2005) (*herein* “Notice 2005-1”).

<sup>4</sup> Prop. Treas. Reg. § 1.409A-1 through § 1.409A-6, *reprinted in* 70 Fed. Reg. 57,930 through 57,984 (Oct. 4, 2005).

<sup>5</sup> 70 Fed. Reg. 57,957 (Oct. 4, 2005).

<sup>6</sup> Notice 2005-94, 2005-52 I.R.B. 1208 (Dec. 27, 2005) (*herein* “Notice 2005-94”). Although not relevant for a tax-exempt employer, the IRS also released guidance regarding valuing stock options and stock appreciation rights.

Notice 2006-4, 2006-3 I.R.B. \_\_ (Jan. 17, 2006) (*herein* “Notice 2006-4”).

<sup>7</sup> IRC § 409A(d)(1)(A).

<sup>8</sup> IRC § 409A(d)(1)(B); Prop. Treas. Reg. § 1.409A-1(a)(1), (2) and (4).

2. *Nonqualified Deferred Compensation Plans Subject to Code § 409A*

Code § 409A applies to nonqualified deferred compensation plans.<sup>9</sup> In particular, Code § 409A generally applies to 457(f) plans, certain “separation from service” arrangements (*i.e.*, severance plans), split-dollar life insurance arrangements under the economic benefit regime, certain post-employment reimbursement arrangements, and certain incentive plans (*i.e.*, bonus programs).

3. *Identifying a Nonqualified Deferred Compensation “Plan” Subject to Code § 409A*

For purposes of Code § 409A, a “plan” is just about any arrangement – including an arrangement that applies to only one person. A plan can be unilaterally adopted or negotiated, and it is irrelevant for purposes of Code § 409A whether the arrangement is a plan under the Employee Retirement Income Security Act of 1974. To *comply* with Code § 409A, the plan must be in writing (although an unwritten plan may be *subject* to Code § 409A).<sup>10</sup>

Where the facts and circumstances reflect manipulation around Code § 409A, Treasury will aggregate arrangements to determine what constitutes a plan. Where there is a Code § 409A violation, the violation is generally imputed to all other like plans of the participant.<sup>11</sup> Note, however, that separation pay (*i.e.*, severance pay) due to an involuntary separation from service or participation in a window program is treated as a separate plan type.<sup>12</sup> For more information about separation pay, see the discussion below.

**B. Code § 409A’s Overlay upon Existing Code Provisions – Variations in Defining a Substantial Risk of Forfeiture**

Any plan subject to Code § 409A must also comply with the underlying Code section governing that plan. For tax-exempt employers, the underlying Code section will most often be § 457(f). Therefore, part of this outline is devoted to the juxtaposition of those two sections.

Code § 457(f) provides that deferred amounts are not taxed until they are no longer subject to a substantial risk of forfeiture (*i.e.*, vested). A primary issue that arises when applying Code § 409A is that certain events that constitute a substantial risk of forfeiture under Code § 457(f) are disregarded when determining the existence of a substantial risk of forfeiture for purposes of Code § 409A. This issue is discussed more fully below.

**C. Consequences of Code § 409A Noncompliance**

For deferred compensation subject to Code § 409A, if the requirements of Code § 409A are not satisfied, three consequences result:

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<sup>9</sup> IRC § 409A(d)(1).

<sup>10</sup> 70 Fed. Reg. 57,942 (Oct. 4, 2005); Prop. Reg. § 1.409A-1(c)(3)(iii).

<sup>11</sup> Prop. Reg. § 1.409A-1(c)(2); Notice 2005-1 Q&A-9.

<sup>12</sup> 70 Fed. Reg. 57,940 (Oct. 4, 2005); Prop. Reg. § 1.409A-1(c)(2)(i)(C).

1. *Income Inclusion*

Compensation deferred in the year of noncompliance and compensation deferred in previous years are includible in the employee's income to the extent that the right to compensation is not subject to a substantial risk of forfeiture (as defined under Code § 409A) or to the extent that it has not already been included in income.<sup>13</sup>

2. *Interest Imposed*

Amounts previously deferred and not included in income are subject to interest imposed at the federal underpayment rate, plus 1%.<sup>14</sup>

3. *Penalty Imposed*

Amounts includible in income are subject to a 20% penalty.<sup>15</sup>

→ Practice Tip: Employers should consider expressly reserving in their plan document the right to amend plans to comply with Code § 409A.

## II. APPLYING RULES FOR INELIGIBLE PLANS UNDER CODE § 457(f) AND CODE § 409A

### A. Code § 457(f) Income Inclusion and Substantial Risk of Forfeiture

Most arrangements of a tax-exempt employer that are subject to Code § 409A are governed by Code § 457(f). Therefore, it is helpful to review the requirements of Code § 457(f).

Tax-exempt employers use 457(f) plans (so-called "ineligible plans") to permit executives and other highly compensated employees to defer compensation and to encourage their continued employment with the tax-exempt organization. Because 457(f) plans are not subject to the restrictions to which other tax-deferred arrangements (such as qualified plans and eligible deferred compensation plans) are subject, 457(f) plans afford tax-exempt employers more flexibility in both plan design and in the amount of compensation that can be deferred.

Under the most basic (and most common) ineligible 457(f) plan design, a tax-exempt employer promises to pay an executive an amount upon death, disability, or at some fixed, future date that is at least two years away. The promise is unsecured and unfunded. If the executive terminates employment prior to the future date (other than on account of death or disability), then he loses his right to compensation. These arrangements typically require payment in a lump sum. As is clear from the principles discussed below, such an arrangement is not deferred compensation subject to Code § 409A because payment occurs in the same year the right to compensation vests (or shortly thereafter). Where, however, the executive is paid more than 2 ½ months after

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<sup>13</sup> IRC § 409A(a)(1)(A).

<sup>14</sup> IRC § 409A(a)(1)(B).

<sup>15</sup> IRC § 409A(a)(1)(B).

the taxable year in which vesting occurs, where the executive rolls the risk of forfeiture, or where the executive vests after satisfying a non-compete agreement, Code § 409A would apply.

The following information summarizes the rules under Code § 457(f), which must be applied before analyzing an agreement under Code § 409A.

1. *Income Inclusion of Amounts Deferred Through a 457(f) Plan*

Under Code § 457(f), compensation (and earnings thereon) deferred to a nonqualified plan of a tax-exempt employer is includible in income when it is no longer subject to a substantial risk of forfeiture (*i.e.*, upon vesting).<sup>16</sup>

2. *Substantial Risk of Forfeiture under Code § 457(f)*

For purposes of Code § 457(f), a “substantial risk of forfeiture” exists where the employee’s right to receive compensation is conditioned, either directly or indirectly, upon his performing (or refraining from performing) substantial services in the future.<sup>17</sup>

a. *Valid Risks of Forfeiture*

Valid risks of forfeiture under Code § 457(f) exist where the executive vests in deferred compensation upon his termination from service due to his death, disability, or after a period of continued employment, generally at least 2 years.<sup>18</sup> The IRS has also ruled that a substantial risk of forfeiture can exist where a participant’s benefits vest at a change in control,<sup>19</sup> or upon an involuntary termination without cause.<sup>20</sup>

b. *Rolling Risks of Forfeiture*

Some 457(f) plans allow extensions of the vesting period on amounts deferred. In the typical situation, an executive may have a vested right to deferred compensation in year 3. In year 2, the executive decides that he wants to continue working for the tax-exempt employer and to continue to defer taxation of compensation in his 457(f) plan. The employer and the executive may renegotiate the vesting date and extend it to year 5. In this example, the parties rolled the risk of forfeiture for 2 additional years.

The IRS scrutinizes these agreements that extend the risk of forfeiture. The IRS requires that the extension be a joint decision by the employer and executive based on a demonstrable, independent business purpose, such as the re-negotiation of the executive’s employment agreement. The IRS is skeptical of arrangements where an executive has a recurring

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<sup>16</sup> IRC § 457(f)(1)(A).

<sup>17</sup> IRC § 457(f)(3)(B); Treas. Reg. § 1.83-3(c).

<sup>18</sup> See, e.g., PLR 2003-21-002; PLR 2001-09-006.

<sup>19</sup> PLR 94-29-007; see PLR 94-31-021 (ruling that a substantial risk of forfeiture existed when vesting postponed from 17 to 33 months under a plan sponsored by a for-profit employer).

<sup>20</sup> PLR 2003-31-002; PLR 1999-43-008; PLR 98-10-005; PLR 89-52-069.

or frequent option to extend the risk, or can extend the period shortly before the risk lapses. The only guidance the IRS has issued in this area is a private letter ruling in which it approved a one-time postponement of vesting.<sup>21</sup> This area, however, continues to be under review by the IRS. As discussed below, for purposes of Code § 409A, any extension of a substantial risk of forfeiture is invalid.

c. **Post-Termination Conditions: Consulting and Non-Compete Agreements**

A 457(f) plan may condition receipt of deferred compensation upon adherence to a non-compete agreement or the performance of post-employment consulting services. There is a rebuttable presumption against these conditions, which means that the executive must demonstrate, based on the facts and circumstances, that there is a real likelihood that he will be called upon to either perform or refrain from performing substantial services. He can rebut this presumption by evidence of the employer's practices, his capability, and the employer's desire for him to be available to the employer, as well as for his talents to remain publicly identified with the employer.<sup>22</sup> Other relevant factors may include the executive's age and health, and the likelihood of other employment opportunities available to him.

As discussed more fully below, for purposes of Code § 409A, non-compete agreements are disregarded when determining the existence of a substantial risk of forfeiture.

**B. Code § 409A Income Inclusion (with Penalties and Interest) and Substantial Risk of Forfeiture**

1. *Nonqualified Deferred Compensation (Including Compensation Deferred Under a 457(f) Plan) Subject to Code § 409A*

a. **Deferred Compensation Subject to Code § 409A**

Code § 409A applies to deferred compensation in a nonqualified plan. As stated above, for purpose of Code § 409A, "deferred compensation" is compensation to which an employee has a legally binding right in one year but is actively or constructively received in another year, and to which an exception from Code § 409A does not apply.<sup>23</sup> Many compensation arrangements that satisfy these criteria are nonetheless excluded from the definition of deferred compensation based on the short-term deferral rule, discussed below.

b. **Short-Term Deferral Exception for Compensation Paid Within 2 ½ Months after the Tax Year in Which Vesting Occurs**

The "short-term deferral" rule provides that compensation actively or constructively received within 2 ½ months after the close of the tax year

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<sup>21</sup> PLR 94-31-021.

<sup>22</sup> GCM (Mar. 29, 1978).

<sup>23</sup> Prop. Treas. Reg. § 1.409A-1(b).

(the later of the employer's or the employee's) in which the compensation is no longer subject to a substantial risk of forfeiture is not "deferred compensation" for purposes of Code § 409A. Therefore, Code § 409A does not apply.<sup>24</sup>

The short-term deferral rule is illustrated by the following example: An executive participating in a deferred compensation plan has a vested right to benefits after remaining employed for 5 years or upon termination due to death or disability. The deferred compensation plan requires that the executive is paid no later than February 1 of the year following the year his compensation becomes vested, and he is paid by that date. The employer's tax year ends on September 30th; the executive's tax year ends on December 31st. Because the executive's compensation is paid before March 15 (2 ½ months after the close of the later of the employer's tax year or the executive's tax year), the executive does not have deferred compensation subject to Code § 409A. The entire amount vested in the deferred compensation plan is includible in the executive's income under Code § 457(f) in the year it is no longer subject to a substantial risk of forfeiture (in this example, the year before the compensation is paid). Code § 409A is never implicated.

→ Practice Tip: Pay close attention to vesting or at least allow payment of some of the benefit to allow the executive to pay any taxes due.

Note that regardless of whether an executive's deferred compensation vests on January 1 or December 31 (or a date in between), it must be paid 2 ½ months after the close of the year to meet the short-term deferral exception.

This 2 ½ month rule takes most 457(f) plans out of the reach of Code § 409A, as most 457(f) plans pay benefits upon an executive's obtaining a vested right to the compensation. Therefore, the executive is paid within 2 ½ months after the year the compensation vests.

Note that the proposed regulations do not *require* that a nonqualified deferred compensation plan specifically state that the deferred compensation will be paid within 2 ½ months after the year the compensation is no longer subject to a substantial risk of forfeiture in order for a plan to take advantage of the 2 ½ month rule, although it is prudent to have it in writing.<sup>25</sup>

2. *Substantial Risk of Forfeiture under Code § 409A – Rolling Risks and Non-Competes Disregarded*

A substantial risk of forfeiture exists under Code § 409A if: (1) a participant's entitlement to an amount requires the performance of substantial future services

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<sup>24</sup> Prop. Treas. Reg. § 1.409A-1(b)(4); Notice 2005-1 Q&A-4(c).

<sup>25</sup> See 70 Fed. Reg. 57,932 (Oct. 4, 2005).

or the occurrence of a compensation-related condition, and (2) the possibility of forfeiture is substantial.<sup>26</sup>

The vesting condition must relate to the participant's performance of service for the employer or the employer's business goals. Unlike Code § 457(f), for purposes of Code § 409A, an amount will not be considered subject to a substantial risk of forfeiture beyond when the participant would have first vested. This means that rolling risks of forfeiture – currently valid for Code § 457(f) – are disregarded under Code § 409A, thereby making Code § 409A applicable to most arrangements where the risk is rolled.<sup>27</sup>

Also, for purposes of Code § 409A, an amount is not subject to a substantial risk of forfeiture solely because the right to receive the amount is conditioned on refraining from performing services. This means that non-compete agreements that are valid under Code § 457(f) are disregarded for Code § 409A.<sup>28</sup> If an executive's deferred compensation arrangement relies upon a non-compete agreement for purposes of Code § 457(f), then it must comply with the requirements of Code § 409A. For purposes of Code § 409A, the non-compete agreement is not a valid substantial risk of forfeiture that would allow the arrangement to be exempt from Code § 409A vis-à-vis the short-term deferral rule. Consider the following example: Assume an executive becomes vested in his benefits under a 457(f) plan one year after he terminates from employment, but only if he complies with the provisions of a non-compete agreement. The non-compete is disregarded when determining the existence of a substantial risk of forfeiture for purposes of Code § 409A; to avoid current inclusion in income, as well as a possible penalty and interest, the executive must comply with the requirements of Code § 409A from the inception of the agreement.

Because Code § 409A disregards rolled risks and non-compete agreements, the substantial risk of forfeiture for purposes of Code § 409A is more restrictive than the substantial risk of forfeiture for purposes of Code § 457(f).

### 3. *Issues Regarding the “Substantial Risk of Forfeiture”*

Because of the variations in a substantial risk of forfeiture, discussed above, a tax-exempt employer (or its advisors) must be aware of where the Code § 409A definition departs from Code § 457(f). This section highlights special concerns and planning with regard to such a departure for purposes of Code § 409A.

#### a. Rolling Risks of Forfeiture

As stated above, a rolling risk of forfeiture permitted under Code § 457(f) is disregarded for purposes of determining whether there is a substantial risk of forfeiture under Code § 409A. Consequently, a rolled risk of forfeiture must comply with the requirements of Code § 409A, which will apply at the inception of the agreement. Rolling the risk is treated as a “subsequent election” to defer, and two requirements must be

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<sup>26</sup> Prop. Treas. Reg. § 1.409A-1(d)(1); Notice 2005-1 Q&A-10(a).

<sup>27</sup> 70 Fed. Reg. 57,942; Prop. Treas. Reg. § 1.409A-1(d)(1); Notice 2005-1 Q&A-10(a).

<sup>28</sup> 70 Fed. Reg. 57,942; Prop. Treas. Reg. § 1.409A-1(d)(1); Notice 2005-1 Q&A-10(a).

met to remain Code § 409A compliant.<sup>29</sup> First, any agreement to extend the vesting schedule must be made at least 12 months before the executive would have otherwise received payment, presumably on or shortly after the date of initial vesting. Second, the vesting schedule must be extended for at least 5 years beyond the original distribution date. These requirements are discussed below.

b. Non-Compete Agreements

As stated above, a non-compete agreement is disregarded for purposes of determining whether there is a substantial risk of forfeiture under Code § 409A. Accordingly, any such arrangement must be Code § 409A compliant. In particular, the plan must provide the date or fixed schedule (or some other Code § 409A-compliant distribution event) to determine when the executive is to receive payment (*e.g.*, a date on or after the completion of the non-compete agreement). These requirements are discussed below.

### III. REQUIREMENTS OF CODE § 409A

This section of the outline discusses the requirements of Code § 409A. These requirements can be divided into three general categories: (1) design and operation, (2) funding, and (3) reporting.

#### A. Design and Operation Requirements of Code § 409A

Nonqualified deferred compensation arrangements subject to Code § 409A must be operated in accordance with the provisions that follow. By the end of 2006, these plans must be amended to contain the following provisions.<sup>30</sup>

1. *Permissible Distributions*

Plan distributions are permitted only upon: (a) separation from service; (b) disability; (c) death; (d) at a specified time or pursuant to a fixed schedule; (e) a change of control; or (f) an unforeseeable emergency, as those terms are defined for purposes of Code § 409A.<sup>31</sup>

If each distribution event is specified, a plan can provide that payment will be at the earliest or latest event to occur. The plan can, however, provide that distributions are permitted at a specified time or pursuant to a fixed schedule *after* the occurrence of a specified event (*i.e.*, separation from service, disability, death, a change in control, or an unforeseeable emergency).<sup>32</sup>

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<sup>29</sup> IRC § 409A(a)(4)(C).

<sup>30</sup> 70 Fed. Reg. 57,954 (Oct. 4, 2005).

<sup>31</sup> IRC § 409A(a)(2)(A); Prop. Treas. Reg. § 1.409A-3(a).

<sup>32</sup> Prop. Treas. Reg. § 1.409A-3(b). At the time of deferral, the date or year must be objectively determinable. Prop. Treas. Reg. § 1.409A-3(g)(1).

a. Separation from Service

- i. The proposed regulations provide that separation from service **does not** occur if there is a continuing employment or consulting relationship.<sup>33</sup>
  - I. Where the parties do not intend separation, annual services and compensation need to be at least 20% of average levels during the preceding three calendar years.<sup>34</sup>
  - II. Where the parties intend separation, annual services and compensation cannot be 50% or more of levels during the preceding three calendar years.<sup>35</sup>
- ii. Determining separation from service is to be done on a controlled group basis.<sup>36</sup> Thus, a plan may not define separation from service as separation from a single company if it is part of a larger group.
- iii. No separation from service occurs while an individual is on military leave, sick leave or other bona fide leave of absence. This treatment only applies for six months unless reemployment is protected by statute or contract.<sup>37</sup>

b. Disability

An employee is considered disabled if: (1) he is unable to engage in a substantial gainful activity because of a medically determinable physical or mental impairment expected to result in death or last for at least one year, or (2) he is receiving income replacement benefits for at least 3 months under an employer-provided accident or health plan because of a medically determinable physical or mental impairment expected to last at least a year. Note that a plan can further limit the definition of disability, and need not include a disability provision.<sup>38</sup>

c. Specified Time or Pursuant to a Fixed Schedule

Amounts are payable at a specified time or pursuant to a fixed schedule if the amounts, and the date payment is to commence, are objectively determinable when the amounts are deferred. An amount is objectively determinable if it is either a stated dollar amount or a formula (*e.g.*, 50 percent of the employee's account balance).<sup>39</sup>

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<sup>33</sup> Prop. Treas. Reg. § 1.409A-1(h)(1)(ii).

<sup>34</sup> Prop. Treas. Reg. § 1.409A-1(h)(1)(ii).

<sup>35</sup> Prop. Treas. Reg. § 1.409A-1(h)(1)(ii).

<sup>36</sup> Prop. Treas. Reg. § 1.409A-1(g).

<sup>37</sup> Prop. Treas. Reg. § 1.409A-1(h)(1)(i).

<sup>38</sup> IRC § 409A(a)(2)(C); Prop. Treas. Reg. § 1.409A-3(g)(4)(i).

<sup>39</sup> Prop. Treas. Reg. § 1.409A-3(g)(1).

d. Change in Effective Control

A change-in-control event must be objectively determinable and any requirement that any other person, such as a plan administrator or board member, certify the existence of a change-in-control event must be strictly ministerial.<sup>40</sup>

Relevant to tax-exempt employers, a change-in-control event most likely arises when a majority of members of an employer's board of trustees is replaced during any 12-month period and is not endorsed by a majority of the members of the corporation's board prior to the change.

e. Unforeseeable Emergency

An unforeseeable emergency is a severe financial hardship of the employee or beneficiary. A plan need not permit a distribution on account of financial emergency, and, if it does, the plan need not permit a distribution on account of all financial emergencies.

Whether an employee has an unforeseeable emergency is based on the facts and circumstances. But no unforeseeable emergency will result if the employee or beneficiary is compensated through insurance or otherwise, if the employee can cover the expense by liquidating assets (so long as the liquidation does not cause a severe financial hardship), or if the employee can cover the expense by ceasing to make deferrals under the plan. The Code § 409A regulations recognize the following events as those constituting an unforeseeable emergency.<sup>41</sup>

i. Illness or Accident

An illness or accident of the employee or beneficiary, the employee's or beneficiary's spouse, or the employee's or beneficiary's dependent.<sup>42</sup>

ii. Property Loss Due to Casualty

A property loss due to casualty occurs when the employee or beneficiary experiences a property loss due to casualty and includes costs to rebuild a home following damage not otherwise covered by insurance.<sup>43</sup>

iii. Other Extraordinary or Unforeseeable Circumstance

The proposed regulations under Code § 409A use as examples of other extraordinary or unforeseeable circumstances some of the bases for satisfying the "immediate and heavy need" prong of the Code § 401(k) safe harbor to satisfy an immediate and heavy

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<sup>40</sup> Prop. Treas. Reg. § 1.409A-3(g)(5)(i).

<sup>41</sup> IRC § 409A(a)(2)(B)(ii); Prop. Treas. Reg. § 1.409A-3(g)(3)(i).

<sup>42</sup> Prop. Treas. Reg. § 1.409A-3(g)(3)(i).

<sup>43</sup> Prop. Treas. Reg. § 1.409A-3(g)(3)(i).

financial need for a hardship distribution (*i.e.*, to prevent foreclosure or eviction from the employee's or beneficiary's primary residence, to pay medical expenses, and to pay funeral expenses). Note that paying college expenses or purchasing a home (which satisfy the Code § 401(k) safe harbor) do not constitute an unforeseeable emergency under Code § 409A.<sup>44</sup>

## 2. *Acceleration of Distributions*

### a. Generally No Accelerated Payment

Generally, a participant may not accelerate the timing or schedule of any payments from a plan subject to Code § 409A.<sup>45</sup>

Nonetheless, the proposed regulations provide that the prohibition on acceleration is not violated if payment is made pursuant to a plan provision or an election that is made at the time of an initial deferral and that requires payment on an accelerated schedule as a result of an intervening event. For example, a plan provides that a participant receives six installment payments, commencing at separation from service. The plan also provides that if the participant dies after the payments commence but before all payments are made, all remaining amounts will be paid as a lump sum.<sup>46</sup>

The prohibition on accelerations is also not violated if the *employer* waives or accelerates a vesting condition, provided that payment is made upon a permissible payment event (*e.g.*, shortens a vesting period from 5 years to 3 years).<sup>47</sup>

Note that switching from installment payments to a lump-sum payment is not acceleration, but it is a change of form of payment that will result in delay of distribution, see discussion below.<sup>48</sup>

### b. Permitted Exceptions to the Prohibition on Acceleration

Accelerations of the time or schedule of payment are permitted in any of the following circumstances:

- i. To fulfill a domestic relations order;<sup>49</sup>
- ii. To comply with a certificate of divestiture;<sup>50</sup>

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<sup>44</sup> Prop. Treas. Reg. § 1.409A-3(g)(3)(i).

<sup>45</sup> IRC § 409A(a)(3); Prop. Treas. Reg. § 1.409A-3(h)(1).

<sup>46</sup> Prop. Treas. Reg. § 1.409A-3(h)(1).

<sup>47</sup> Prop. Treas. Reg. § 1.409A-3(h)(1).

<sup>48</sup> Prop. Treas. Reg. § 1.409A-2(b)(3).

<sup>49</sup> Prop. Treas. Reg. § 1.409A-3(h)(2)(i); Notice 2005-1 Q&A-15(b).

<sup>50</sup> Prop. Treas. Reg. § 1.409A-3(h)(2)(ii); Notice 2005-1 Q&A-15(c). A certificate of divestiture is a document issued by the Office of Government Ethics to a participant who is required to sell an asset to eliminate a conflict

- iii. To permit a de minimis payment or specified amount;<sup>51</sup>
- iv. To pay income taxes due upon a vesting event in a 457(f) plan, but the payment amount being accelerated may not exceed the amount of income tax due;<sup>52</sup>
- v. To pay employment taxes on compensation deferred under the plan (regardless of whether the plan is a 457(f) plan);<sup>53</sup>
- vi. To pay income taxes due upon the plan's failure to satisfy the requirements of Code § 409A;<sup>54</sup>
- vii. To cancel (not postpone) deferrals after a distribution on account of an unforeseeable emergency or a distribution from a Code § 401(k) plan on account of a hardship. After the cancellation, any later deferral is subject to the rules regarding initial deferrals;<sup>55</sup> and
- viii. To pay the employee upon the employer's termination of the plan (which termination will also likely have to comply with Code § 409A).<sup>56</sup>

## **B. Initial Election to Defer and Form of Distribution**

### *1. Deferral of Compensation Under Code § 457(f).*

Because of the nature of Code § 457(f), where the deferred compensation must be subject to a substantial risk of forfeiture, it is highly unusual for executives to want to defer a portion of their own compensation through a salary or bonus deferral program.<sup>57</sup> Rather, under most 457(f) arrangements, the employer provides the deferred compensation over and above an executive's salary or bonus. Nonetheless, if an arrangement provides for elective deferrals the deferral

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between that financial interest and the participant's official responsibilities. The certificate permits the participant to defer recognition of gain that results from the forced sale.

<sup>51</sup> Prop. Treas. Reg. § 1.409A-3(h)(2)(iv); Notice 2005-1 Q&A-15(e). A plan that does not provide for de minimis cashout payments may be amended to permit the acceleration of a payment if: (1) The payment is of the participant's entire interest in the plan; (2) the payment is made on or before the later of (A) December 31st of the calendar year in which the participant has a separation from service, or (B) 2 ½ months after the participant's separation from service; and (3) the payment is \$10,000 or less. This amendment can be made with regard to both previously deferred amounts and future deferrals. Also, a plan can be amended with regard to future deferrals to provide that if a participant's interest is less than a specified amount when the amount is otherwise payable under the plan, then the participant's entire interest must be distributed as a lump-sum payment.

<sup>52</sup> Prop. Treas. Reg. § 1.409A-3(h)(2)(iii); Notice 2005-1 Q&A-15(d). This exception recognizes that, even if a participant in a 457(f) plan is paid in the form of an annuity, he is taxed on the present value of his stream of annuity payments (potentially creating a large tax bill, but with no present income to pay it).

<sup>53</sup> Prop. Treas. Reg. § 1.409A-3(h)(2)(v); Notice 2005-1 Q&A-15(e).

<sup>54</sup> Prop. Treas. Reg. § 1.409A-3(h)(2)(vi).

<sup>55</sup> Prop. Treas. Reg. § 1.409A-3(h)(2)(vii).

<sup>56</sup> Prop. Treas. Reg. § 1.409A-3(h)(2)(viii).

<sup>57</sup> Cf. PLR 92-12-006.

election generally must be made before the year in which the relevant services are performed.<sup>58</sup>

2. *Form of Distribution Election Under Code § 409A at Time of Deferral*

Code § 409A requires that the form of distribution either be elected by the employee or specified by the employer at the time of initial deferral.<sup>59</sup> As a practical matter, in the majority of cases involving 457(f) plans, there will be no choice: the sole form of distribution will be a lump sum, allowing the participant to receive payment upon vesting to pay taxes and keep the remainder. Where there *are* distribution options from which to choose, the executive must make the election prior to the service period during which he or she otherwise “earns” the deferred compensation.<sup>60</sup>

**C. Election to Extend Deferral Period or Change Form of Payment**

Code § 409A permits participants to extend their deferral periods or change their forms of payment, or both, provided the following rules are satisfied.

1. *12 Months Prior*

A participant may defer his receipt of deferred compensation or change the form of payment by making an election to defer or change the form of payment no later than 12 months prior to the date distribution is to otherwise commence.<sup>61</sup>

2. *5 Year Deferral*

The date of distribution must be delayed at least five years from the original date of distribution.<sup>62</sup> As discussed above, this rule will likely need to be satisfied if an employer and the executive want to roll the risk of forfeiture under Code § 457(f).

**D. Funding Requirements Prevent Going Offshore**

Sometimes employers place assets designated to pay deferred compensation in a grantor trust, called a “rabbi trust.” In a more aggressive strategy, employers will create the trust under laws of a foreign jurisdiction because although the trust remains subject to the claims of the employer’s general creditors (so the employee is not taxed on the trust assets), the laws of the foreign jurisdiction make it more difficult for assets to be seized. Code § 409A was drafted to deter offshore arrangements. If a rabbi trust holds plan assets and it is placed in a foreign jurisdiction, the participant is subject to current taxation on the amount placed offshore, plus a 20% penalty, and interest under Code § 409A.<sup>63</sup>

**E. Additional Requirement to Report at Deferral**

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<sup>58</sup> See IRC § 457(f)(3)(b); PLR 92-12-006.

<sup>59</sup> IRC § 409A(a)(4)(B).

<sup>60</sup> Prop. Treas. Reg. § 1.409A-2(a)(1).

<sup>61</sup> IRC § 409A(a)(4)(C)(iii).

<sup>62</sup> IRC § 409A(a)(4)(C)(ii).

<sup>63</sup> IRC § 409A(b)(1), (3), and (4).

Code § 409A requires an employer to report any deferral of compensation of more than \$600.<sup>64</sup> This reporting requirement is in addition to the requirement that compensation be reported when paid.<sup>65</sup>

For 2005, the IRS suspended the obligation imposed by Code § 409A for employers to report nonqualified deferred compensation, both when deferred and when includible in income. Regarding 2006, the IRS is working on reporting and withholding guidance that is expected to be released during the first half of 2006.<sup>66</sup>

The separate reporting requirement appears to fulfill two goals: first, to enable the IRS to track deferred compensation better, and second, to facilitate calculation of any penalty and interest charges for noncompliance with Code § 409A for amounts not previously included in income.

#### **IV. INCENTIVE PLANS**

Depending on its structure, performance-based compensation paid to an executive after attaining a performance goal may be subject to Code § 409A.

##### **A. Definition of Performance-Based Compensation**

“Performance-based compensation” is compensation whereby the amount or entitlement is contingent upon meeting pre-established performance criteria relating to a performance period of a year or longer.<sup>67</sup>

If bonus compensation is based on subjective performance criteria, the subjective criteria (1) must relate to the performance of the employee, a group of employees that includes the employee who is participating in the plan, or a business unit for which the employee provides services; and (2) the determination that the subjective criteria have been met must not be made by the employee, a member of the employee’s family, or a person either under the supervision of the employee or the employee’s family member or whose compensation is controlled by the employee or the employee’s family member.<sup>68</sup>

##### **B. Performance-Based Compensation Typically Excluded from Code § 409A Vis-à-vis the Short-Term Deferral Rule**

Typically, an employee who is eligible for performance-based compensation has no vested right to the compensation until the end of the performance period, once performance goals are met. Upon an employee’s satisfaction of the performance goals, an employer routinely pays the compensation within 2 ½ months of the year after the employee earns the performance compensation. Under this scenario, the performance-

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<sup>64</sup> IRC § 6041(g)(1) (independent contractors); IRC § 6051(a)(13) (employees).

<sup>65</sup> IRC § 3401(a) (flush language) (employees); IRC § 6041(g)(2) (independent contractors). For additional information on reporting and withholding, see Notice 2005-1 Q&A-24 through Q&A-38; Notice 2005-94; Announcement 2004-96; Announcement 2005-5; IRS Publication 15A; 2005 IRS Form 1099-MISC Instructions p.7; 2005 IRS Form 1040 Instructions p.44.

<sup>66</sup> Notice 2005-94.

<sup>67</sup> Prop. Treas. Reg. § 1.409A-1(e)(1).

<sup>68</sup> Prop. Treas. Reg. § 1.409A-1(e)(2); *see* Notice 2005-1 Q&A-22.

based compensation is not subject to Code § 409A because payment falls within the 2 ½ months of vesting, fitting within the short-term deferral exception discussed above.

→ Practice Tip: If there are circumstances that prevent an employer from paying incentive compensation within 2 ½ months of the year in which the performance period ended, for example, a bonus award contingent upon board approval in the subsequent year, the payment will be subject to Code § 409A. Nonetheless, by setting a payment date that will assuredly be after the board meets to review and approve the bonus, the employer will meet the Code § 409A distribution requirements.

### **C. Special Deferral Rule for Performance-Based Compensation Subject to Code § 409A**

If an employee wants to defer payment of a bonus to a later year, the employee is permitted to move his or her initial deferral election at least six months before the end of bonus performance period (rather than the general rule requiring a deferral election in the year before services will be performed).<sup>69</sup>

## **V. “SEPARATION FROM SERVICE” PAYMENTS**

Although most severance plans are not governed by Code § 457(f),<sup>70</sup> they may be governed by Code § 409A.

### **A. Severance Exclusion from Code § 409A**

#### *1. Collectively Bargained Separation Pay*

Separation pay that is the product of a collective bargaining agreement is also excluded from Code § 409A. The separation pay must be provided upon an involuntary termination or pursuant to a window program.<sup>71</sup>

#### *2. Involuntary Termination with Limited Payment Amount and Duration*

Code § 409A excludes a “separation from service” arrangement from its coverage if the arrangement satisfies the following three criteria:<sup>72</sup>

##### **a. Involuntary Termination or Participation in a Window Program**

The arrangement must provide for payment *only* upon involuntary termination, or under a window program (with a window of not more than 1 year). Constructive termination and termination for good reason are not treated as involuntary termination for this purpose.

##### **b. Limited Payment Amount**

<sup>69</sup> IRC § 409A(a)(4)(B) (i) and (iii); Notice 2005-1 Q&A-22.

<sup>70</sup> IRC § 457(e)(11) provides for a specific exclusion of bona fide severance pay plans.

<sup>71</sup> Notice 2005-1 Q&A-19(d); Prop. Treas. Reg. § 1.409A-1(b)(9)(ii).

<sup>72</sup> 70 Fed. Reg. 57,940.

The payment may not be for more than two times the lesser of the employee's annual compensation or the compensation limit for qualified plans under Code § 401(a)(17) for the year prior to the year in which the termination occurs (*i.e.*, \$210,000 in 2005).<sup>73</sup>

c. Limited Payment Duration

No payments may continue beyond the end of the second calendar year following the year in which the termination occurs.<sup>74</sup>

**B. Conforming Separation Pay for Code § 409A Compliance**

It is rather painless to structure severance payments that might not meet the exceptions described above to be Code § 409A compliant. Code § 409A permits distributions upon separation from service or upon a specified time (or pursuant to a fixed schedule) provided in the plan when the compensation is deferred.<sup>75</sup> Therefore, if the plan provides separation payment upon separation from service in a lump sum, or provides payment pursuant to a fixed schedule, then the plan likely complies with Code § 409A's distribution requirements.

**C. Separation Pay Constitutes a Separate Category of Plan Type for Purpose of Plan Aggregation**

As discussed above, separation pay arrangements constitute a category of plan type, which is separate from the account balance plan, the non-account balance plan, and "other" (generally equity award) plan categories.<sup>76</sup> This separate treatment means that violating a Code § 409A requirement with regard to a separation pay arrangement does not taint another category of plan type.

**VI. REIMBURSEMENT AGREEMENTS**

**A. Reimbursement Agreements Generally Subject to Code § 409A**

Reimbursement arrangements (*e.g.*, tax-preparation fees, financial planning expenses, country club dues, relocation expenses) are generally deferred compensation subject to Code § 409A. Subject to the exceptions below, Code § 409A generally applies because these arrangements typically involve an employer's promise to reimburse a former employee, which is generally not subject to a substantial risk of forfeiture. Therefore, if the period in which expenses incurred will be reimbursed after the year in which the legally binding right arises (often at inception of employment), then the right to the amount generally constitutes deferred compensation subject to Code § 409A.

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<sup>73</sup> Prop. Treas. Reg. § 1.409A-1(b)(9)(iii)(A).

<sup>74</sup> Prop. Treas. Reg. § 1.409A-1(b)(9)(iii)(B).

<sup>75</sup> IRC § 409A(a)(2)(A)(i) and (iv).

<sup>76</sup> 70 Fed. Reg. 57,940; Prop. Treas. Reg. § 1.409A-1(c)(2)(i)(C).

Also, rules regarding reimbursement arrangements apply not only to cash reimbursements, but also to in-kind benefits and payments by the employer directly to the company providing services to the terminated employee.<sup>77</sup>

## **B. Exceptions – Permitted Reimbursement Agreements Excluded from Code § 409A**

In recognition that reimbursement arrangements post-employment are commonplace and that an employer wants to pay as a reimbursement only costs actually incurred by the employee (rather than a fixed amount), the proposed regulations contain the following two exceptions, which permit reimbursement arrangements that are not subject to Code § 409A.

### *1. Certain Excludible or Deductible Expenses Incurred Within Two Years of Terminating Employment*

The proposed regulations exclude from coverage under Code § 409A certain reimbursement arrangements related to termination of services, so long as the reimbursement arrangement covers only expenses (1) that would otherwise be excludible from gross income or deductible as a business, outplacement, moving, or medical expense; and (2) that were incurred *and reimbursed* by the end of the second calendar year following the year in which the termination occurs. Under this provision, the reimbursement of medical expenses exclusion applies regardless of whether the separation from service was voluntary or involuntary.<sup>78</sup>

Note that if an employer provides these benefits beyond the two-year exclusion period, employers are required to value the benefits provided (not an easy task) for purpose of reporting, as described below.

### *2. De Minimis Reimbursement Agreement Exclusion*

The proposed regulations also exclude from coverage under Code § 409A reimbursements that do not exceed \$5,000 per year.<sup>79</sup>

## **VII. BONA FIDE VACATION-LEAVE AND SICK-LEAVE PLANS**

### **A. Not Deferred Compensation**

Bona fide vacation-leave plans and sick-leave plans are not deferred compensation plans for purposes of Code § 457(f) or Code § 409A (and therefore are not subject to either provision).<sup>80</sup>

### **B. Determining Whether Plan Is Bona Fide**

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<sup>77</sup> 70 Fed. Reg. 57,941.

<sup>78</sup> Prop. Treas. Reg. § 1.409A-1(b)(9)(iv).

<sup>79</sup> Prop. Treas. Reg. § 1.409A-1(b)(9)(iv)(C).

<sup>80</sup> IRC §§ 457(e)(11) and 409A(d)(1)(B).

The IRS has not issued formal guidance defining a bona fide vacation or sick leave program, although in private letter rulings, it has enumerated factors to make such a determination.<sup>81</sup> The IRS considers factors such as:

1. *Excessive Amounts*

If the amount of annual leave or total leave is excessive, this factor favors concluding that the arrangement is not bona fide leave but rather, deferred compensation.

2. *Reasonable to Use Leave*

If there is no reasonable expectation that an employee in the leave program can use all of the leave that accumulates over time, this factor favors concluding that the arrangement is not bona fide.

## VIII. SPLIT-DOLLAR LIFE INSURANCE ARRANGEMENTS

Code § 409A applies to a split-dollar life insurance arrangement under the “economic benefit” regime (as does Code § 457(f)), whereby the underlying life insurance policy is owned by the employer (so-called “equity split-dollar”). Code § 409A does not, however, apply to split-dollar life insurance arrangements providing only a death benefit or to arrangements under the loan regime, so long as there is no agreement between the employer and the employee whereby the employer will forgive the loan.<sup>82</sup>

A myriad of issues arise regarding the effect of Code § 409A on equity split-dollar arrangements. For example, one issue is whether making such a split dollar arrangement Code § 409A compliant would constitute a material modification under the split-dollar rules. Treasury officials have been clear that they are “sensitive” to the issues surrounding equity split-dollar and advise employers to wait until further guidance.

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<sup>81</sup> See PLR 2003-51-002; see also PLR 2004-50-010.

<sup>82</sup> 70 Fed. Reg. 57,941.