On April 10, 2007, the Internal Revenue Service (IRS) issued the final rules on §409A (409A) after a comment period during which groups as diverse as the National Employment Lawyers Association and the American Bar Association, among others, lobbied aggressively on behalf of employers and executives as well as rank-and-file employees.

While the final rules show some improvements and clarifications over the proposed regulations, employees and their attorneys will be challenged to become expert quickly in tax issues that would be more reliably left to tax professionals.

Moreover, while employers are required to comply with the final regulations, the rule still requires onerous tax penalties for employees if their employers' plans and agreements do not comply. Surely, attorneys representing these clients in contract negotiations do not want to hear from their clients years later that the benefit of their bargain was reduced by at least a 20 percent tax penalty.

As a result, attorneys who represent employees in negotiating employment and severance agreements must be familiar with 409A and understand how it affects cash and equity compensation arrangements and separation pay. Attorneys may also want to review their clients' existing plans and employment agreements to discuss alternative arrangements if the pre-409A arrangements are no longer appropriate under the new and now final rules.

**Before 409A**

Under prior law, unfunded non-qualified deferred compensation (NQDC) arrangements taxed employees only when amounts were actually or constructively received as income rather than when the promise to pay was made, the services performed, or the employees' right to the compensation vested. This favorable tax treatment encouraged
employers to offer deferred compensation in a myriad of forms, such as deferred bonus plans, short- and long-term compensation plans, nonqualified stock option plans, supplemental retirement plans, and other nonqualified equity and cash plans. Most important to this discussion is the fact that severance pay, now called "separation pay" by the Internal Revenue Service (IRS), was not considered deferred compensation.

**Deferred Compensation After Final Rules**

Spurred by the release of the Senate Finance Committee's Enron Report,\(^4\) which detailed the ability of executives to cash out deferred benefits even while their company was sinking, President George W. Bush signed into law §409A\(^5\) of the Internal Revenue Code (the Code) as part of the American Jobs Creation Act of 2004.\(^6\) The enactment of 409A, the subsequent IRS Notice 2005-1 (the Notice),\(^7\) the published proposed regulations,\(^8\) and now the final regulations\(^9\) redefined and significantly limited all NQDC plans\(^10\) offered to employees and other participants.\(^11\) Section 409A applies not only to employer-sponsored plans, but also to agreements between employers and employees.

The final regulations confirm the approach taken in Notice 2005, which defined deferred compensation as a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income if, under the terms of the plan, the compensation is payable to (or on behalf of) the employee or "service provider" in a later year.\(^12\) A legally binding right exists as long as the employee will have a right to the compensation if its conditions are satisfied. Thus, an employee can have a right to compensation before it exists, is received or vested. As applied, 409A not only affects deferred compensation plans but also certain equity plans, annuity plans, stock appreciation rights (SARs), phantom stock plans, and separation pay arrangements, as a result of both voluntary and involuntary separation from service.

The 397-page final regulations follow the same format as the proposed regulations by adopting definitions, clarifying issues raised by numerous public comments, expanding previous exceptions to the rules, and providing some examples. The final regulations also require that deferred compensation plans be set forth in writing. This knowledge is critical for attorneys representing employees.

Since employment and separation agreements are plan documents, the final regulations are required reading for attorneys negotiating employment and severance agreements for employers or employees. Some of the highlights, while not inclusive of all the changes in the final regulations, follow:

**Short-Term Deferrals\(^13\)**

Under the final regulations, compensation that is paid within 21/2 months of the end of the calendar year in which
it was earned is not considered deferred compensation. Previously, this short-term exception applied to performance-based pay and severance pay but had not been available to key employees subject to the six-month waiting period. The final regulations allow key employees to take limited advantage of this rule.

The rule also permits payments to be delayed beyond this period if payment would jeopardize an employer’s ability to remain in business, payment would be administratively impracticable, or delay is required for the amount to be deductible (notwithstanding §162(m) of the Code concerning a $1 million limit). It is worth noting that if a plan that would allow payments to be made later than the 21/2-month period, employees cannot take advantage of the short-term deferral rule.

**Severance Benefits**

The final regulations clarify that separation pay is compensation conditioned on separation from service (including separation on account of death and disability), not compensation without a separation, such as on a change in control. There are four exempt separation pay plans: collectively bargained plans, involuntary separation pay plans and voluntary window programs, certain foreign plans, and plans that provide in-kind benefits or reimbursements in connection with a separation from service. There is also an exception for plans that do not exceed the limit under §402(g) of the Code.

Involuntary separation pay arrangements are not subject to 409A as long as the payment does not exceed two times the compensation limit ($225,000 for 2007) for qualified retirement plans or two times salary, whichever is less, and is payable within two and a half years after separation. In keeping with this concept, the final rules allow limited severance pay to key employees who are involuntarily terminated without waiting for the six-month delay period.

It is important to be aware that separation pay does not apply to amounts that replace deferred compensation to which the employee may be entitled to in the future (or not at all if the separation was voluntary). The final rules create a presumption that payments proximate to purported forfeitures or voluntary relinquishments of deferred compensation are presumed to be substitutes for deferred compensation, but that presumption can be rebutted.

Finally, it should be noted that separation pay arrangements negotiated immediately before termination are not considered deferred compensation if paid in the same taxable year in which termination occurs or within the short-term deferral period.

- **Reimbursement, In-Kind Benefits.**
The final regulations clearly give more flexibility to continuing reimbursements and in-kind benefits to employees than was seen previously. The final regulations expand this exception to cover any reimbursement that is includible in gross income, provided in either a voluntary or involuntary termination, so long as expenses are incurred or in-kind benefits provided by the end of the second year following the year in which separation occurred, and reimbursements are paid by the end of the third year. These include moving expenses, outplacement, legal fees, or medical and other reimbursed expenses. Also, in-kind benefits comparable to reimbursed expenses are exempt from 409A, such as use of a company car or a home office. Reimbursement for medical benefits can be made through the employee's COBRA period without being subject to 409A; beyond that period, they will be subject to 409A.\(^\text{18}\)

**Good Reason Resignation**\(^\text{19}\)

The final regulations did a complete reversal on the issue of good reason resignation and treat it as an involuntary termination, rather than as a suspect form of voluntary resignation. Under these rules, the right to separation pay becomes vested when the "good reason" event takes place, allowing employees who resign for "good reason" to avail themselves of the 409A exceptions.

The final regulations provide for a "facts and circumstances" rule to determine when a "good reason" resignation is treated as an involuntary termination.

There is a "safe harbor" definition of "good reason," which includes requirements such as notice and an opportunity to cure, as well as requiring the amount, time, and form of payment to be substantially the same as it would be in an involuntary separation. "Good reason" under the safe harbor provision is limited to material diminution in base compensation; material diminution in authority, duties and responsibilities; material diminution in budget under the employees control; material change in location; or material breach of the employment agreement.

- **Negotiated Settlements of Voluntary and Involuntary Separations**\(^\text{20}\)

For employment attorneys, this section of the final regulations remains open-ended and gives insufficient guidance. When there is a dispute over whether a separation was voluntary, involuntary, for cause, or for a wrongful reason, the final rules seem to allow for acceleration of deferred compensation when there is a settlement. However, because the guidance is vague, consultation with a tax professional is recommended to plan what, if any, safe harbors are available.

**Change in Control**\(^\text{21}\)
The final regulations did not make significant changes to the definition of a change in control but did lower from 35 percent to 30 percent the percentage of change in voting power when an individual or group acquires stock. Also, 280G tax "gross ups" can now avoid 409A penalties if they are paid by the end of the calendar year after the taxes are paid to the IRS or by the end of the calendar year after the year in which disputed taxes are paid following audit.

Separation From Service\textsuperscript{22}

The final regulations clarify when separation occurs in order to alleviate some of the confusion over sabbaticals, consulting, and other continuation of employment conditions. In short, there is a termination of employment if the level of services to be performed after the termination is no more than 20 percent of the average amount performed over the prior 36 months, and is not a separation if the level of service is 50 percent or more. The amount of compensation appears to no longer be an issue in the final rules.

Specified Employees\textsuperscript{23}

Specified employees, or key employees (defined in 416 (i) of the Code), who separate from employment could not, under the proposed regulations, receive distributions earlier than six months after the date of separation. This requirement was not delayed by the proposed regulations and became effective on Jan. 1, 2006.\textsuperscript{24} An employee of a company with publicly traded stock is a "specified employee" if he owns more than 5 percent of the stock; owns more than 1 percent of the stock and has compensation over $150,000 annually; or is one of no more than 50 officers of the company with annual compensation over $145,000.

In addition to allowing specified employees to take advantage of the short-term deferral rule and safe harbors for involuntary separation, the final rules also allow an employer to use an alternative simplified method to determine who its specified employees are.

\textbullet\; Stock Options, Exercise Periods\textsuperscript{25}

There are significant changes in the valuation of options and SARs as well as definitional changes concerning service recipient stock under the final regulations. The regulations also provide that extending the exercise period will not cause a stock right to be subject to 409A if the period is not extended beyond the original term of the right or 10 years from the date of the grant, or if the stock option is underwater.

Certain Waivers, Conditions
The final rules reconfirm that all amounts deferred for all tax years are includible in current gross income to the
extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless strict
deferral election requirements are met. However, according to the IRS’s guidance in the final rule's preamble, a
waiver or release of claims or a restrictive covenant in an employment or severance agreement will not subject an
employee's separation pay to a substantial risk of forfeiture nor remove it from being subject to 409A. According
to the guidance, where the employee retains discretionary control over the performance of a condition (such as
whether to sign a noncompetition agreement or to release claims), a substantial risk of forfeiture does not exist
and the separation pay is deferred compensation subject to 409A.

Transition Rules

There are detailed transitional rules that provide some relief if a good-faith effort to comply is shown. However, it
is clear that the effective date of Jan. 1, 2008, will not be extended. Also, Daniel Hogans, a spokesman for the U.S.
Treasury Department, advised at a recent ABA teleconference that merely putting a savings clause in an
agreement that states a good faith effort to comply will not save an employee from incurring substantial tax
penalties if the plan or agreement is noncompliant.

Conclusion

As expected, 409A is a challenge to any practicing attorney, especially those not practicing in the tax area. That
said, it is incumbent on employment attorneys - both employer- and employee-side - to discuss these rules in a
severance or employment agreement negotiation and insure that a good-faith effort is made to comply with the
regulations in order for the executive or employee to avoid liability. Hopefully, the IRS will issue further guidance
on the less clear issues to assist us in this effort.

Wendi S. Lazar is of counsel to Outten & Golden. Katherine Olshansky, a law clerk at the firm, assisted in the
preparation of this article, and Cara E. Greene, an associate at the firm, assisted in the research.

Endnotes:


2. IRS Notice 2005-1 was the first part of the guidance on 409A provided by the Internal Revenue Service; it
provided guidance on the application of the new regulations as well as useful definitions and a lengthy Q&A about
409A. See IRS Notice 2005-1, 2005-2 I.R.B. 274 (Jan. 10, 2005). The proposed regulations on 409A were officially


10. The types of plans considered to be NQDC for example are elective and non elective deferred compensation plans, bonus, SERP, equity compensation, and separation plans where employee has a legally binding right to receive compensation in a year later than the one in which it was earned.


12. Id. Q&A-4(a); 26 CFR §1.409A-1(b)(1).


15. 26 CFR §1.409A-3(f).


18. Certain benefits, e.g., disability, healthcare, etc., which are otherwise not includible in income are not
considered to be deferred compensation.


21. 26 CFR §1.409A-3(i)(5).


23. 26 CFR §1.409A-1(i).


26. Compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation (such as meeting company performance targets), and the possibility of forfeiture is substantial. 26 CFR §1.409A-1(d).


28. Id.

29. Preamble §§XIII (B).