

*Representing Employees in the Brave New World of 409A: New Rules on Deferred Compensation and Severance\*\*\**

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After the release of the Senate Finance Committee's Enron Report<sup>1</sup>, which detailed the ability of executives to cash out deferred benefits even while their company was sinking, President Bush signed into law Section 409A ("409A")<sup>2</sup> of the IRS Code (the "Code") as part of the American Jobs Creation Act of 2004<sup>3</sup> (the "Act"). While recent IRS guidance and proposed regulations<sup>4</sup> are not yet final, it is clear that traditional deferred compensation arrangements are no longer suitable for rewarding executives and other employees. Moreover, while employers (and other plan providers) have an obligation to comply, the law's onerous tax penalties fall upon employees, if their employers' plans and agreements do not comply.<sup>5</sup>

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 severance pay. Attorneys may also want to review their clients' existing plans and agreements and to discuss alternative arrangements, if the pre-409A arrangements are no longer appropriate under the new rules.

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<sup>1</sup> See generally Joint Committee on Taxation, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (JCS-3-03), February 2003 ("The Joint Committee Report").

<sup>2</sup> See 26 USC 409 (2005).

<sup>3</sup> American Jobs Creation Act of 2004, Pub. Law No. 108—357, 118 Stat. 1418 (2004).

<sup>4</sup> 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 regulation 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 regulation on 409A was officially published in the Federal Register on October 4, 2005. It provides more information regarding the implementation and effect of 409A on deferred compensation, however, it can be amended subject to the comments received by IRS and changes IRS makes to the regulations until they are finalized and become effective on January 1, 2007. All tax payers should rely on the proposed regulations until finalized. See Prop. Reg. 1.409A (October 4, 2005).

<sup>5</sup> See 26 USC 409A (a)(1)(B)(2005).

## **Deferred Compensation Before 409A**

Under prior law, unfunded non-qualified deferred compensation (NQDC) arrangements taxed employees only when amounts were actually received as income, rather than when the promise to pay was made, the services performed, or the employee's right to the compensation vested. This favorable tax treatment resulted in employers offering employees deferred compensation in a myriad of forms, such as deferred bonus plans, short-and-long term compensation plans, non-qualified stock option plans, supplemental retirement plans, and other non-qualified equity and cash plans.<sup>6</sup>

Employers were also allowed to hold funded *rabbi* and *springing* trusts for highly compensated executives<sup>7</sup> before 409A<sup>8</sup>. These trusts hold assets for an employee's benefit and are subject only to the claims of the employer's creditors in the event of insolvency or bankruptcy.<sup>9</sup>

## **Deferred Compensation after 409A**

The enactment of 409A, the subsequent IRS Notice 2005-1 (the "Notice")<sup>10</sup> and the published proposed regulations<sup>11</sup>, redefined and significantly limited all non-qualified deferred compensation plans<sup>12</sup> offered to employees and other plan participants.<sup>13</sup> Under 409A, deferred compensation is defined as a (1) legally binding right during a taxable year to compensation that has not been actually or constructively received and included in income, and (2) under the terms of the plan, the compensation is payable to

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<sup>6</sup> See generally the Joint Committee Report.

<sup>7</sup> See generally the Joint Committee Report.

<sup>8</sup> See 26 USC 409 (b) (2005). 409 (b) prohibits these types of deferred compensation schemes. Offshore trusts will now have their assets taxed when vested.

<sup>9</sup> *Id.*

<sup>10</sup> IRS Notice 2005-1, 2005-2 I.R.B. 274 (Jan. 10, 2005).

<sup>11</sup> See Prop. Reg. 1.409A (October 4, 2005).

<sup>12</sup> 409A applies not only to employer-promulgated plans, but also to agreements between employers and employees. Notably, 409A applies not only in the employment context but in other contexts involving compensation. Thus, the regulations refer to "service providers" (which includes employees) and service recipients (which include employers).

<sup>13</sup> IRA Notice 2005-1, *supra* note 10. Notably, 409A does not alter or affect the application of any other provision of the Code or common law tax doctrines.

(or on behalf of) the service provider in a later year.<sup>14</sup> As applied, 409A also affects certain equity plans, stock appreciation rights (“SARs”) and severance plans.

The most significant change brought about by 409A is 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<sup>15</sup> and not previously included in gross income), unless strict deferral election requirements are met (as discussed below). Besides being immediately taxed, all non-compliant compensation will incur an interest charge and a 20% excise tax on the amount included in the person’s income, plus a 1% interest penalty.<sup>16</sup>

Sections (a)(2), (3) and (4) of 409A set forth the main requirements for NQDC plans. The failure to meet all requirements will cause all deferred compensation for the current tax year, plus for any prior tax year not already included in gross income, to be included in gross income and taxed for that year.

The new rules apply to amounts deferred after December 31, 2004. Amounts deferred before then (plus earnings on those amounts) are not subject to 409A unless the plan was materially modified after October 3, 2004.<sup>17</sup> Under the proposed regulations, the deadline for compliance is December 31, 2006, in most, but not all, instances (as discussed below).<sup>18</sup>

The most important requirements imposed by 409A on every NQDC plan are as follows:

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<sup>14</sup> *Id.* Q&A-4(a); Prop. Treas. Reg. 1.409A-1(b)(1).

<sup>15</sup> *Id.* 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 substantial future services), and the possibility of forfeiture is substantial.

<sup>16</sup> *See* 26 USC 409A (a)(1)(B), (b)(4)(2005).

<sup>17</sup> A plan is materially modified if it adds a new benefit to the plan, even if that benefit is permitted under 409A. A plan is not materially modified if it is changed to comply with 409A without adding new benefits or without changing or adding any investment measures. When changing their plans in accordance with 409A, plan providers have to be careful to change the plans without adding new benefits or adding any investment measures, otherwise the plan will automatically be subject to 409A and taxed and penalized under it. *See* IRS Notice 2005-1, 2005-2 I.R.B. 274, Q&A 16 (Jan. 10, 2005).

<sup>18</sup> *See supra* note 11.

- Where deferred compensation is elective, the deferral election must be made before the start of the year during which the service justifying the compensation begins.<sup>19</sup> For newly eligible employees, a special rule allows an election within 30 days of eligibility.<sup>20</sup>
- Any election to change the time or form of distribution of previously deferred compensation must be made 12 months before the original beginning date and must “season” for 12 months before the new deferral takes effect. With respect to the further election, no payment can be made until five years after the original specified payment date.<sup>21</sup>
- With respect to performance-based compensation for services performed for a period of not less than 12 months, the election must be made no later than 6 months before the end of the performance period.<sup>22</sup>
- Distributions can occur only under a limited set of circumstances including separation from employment, death, disability, other unforeseeable and extreme circumstances, and major changes in corporate control.<sup>23</sup> Furthermore, all of these times and events must appear in the plan to be effective.<sup>24</sup>
- Accelerated payments such as “haircut” provisions are now barred, unless otherwise permitted by regulation.<sup>25</sup> Once a time is set in a NQDC plan, the provider of the plan is barred from any acceleration of payment.
- Executives who are “key employees<sup>26</sup>” at publicly traded companies are prohibited from receiving compensation triggered by their separation until after a six-month waiting period.<sup>27</sup> (*See* discussion of severance below)

Regarding stock options and SARs, the significant requirements of 409A are as follows:

- Incentive Stock Options (ISOs) and Non-Qualified Stock Options (NSOs) issued with an exercise price of not less than fair market value on the date of grant are not considered a deferral and are not be subject to 409A.<sup>28</sup> NSOs with an exercise price that is less than fair market value on the grant date, however, will be subject to 409A.<sup>29</sup>

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<sup>19</sup> *See* 26 USCS 409A (a)(4)(2005).

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> *See* 26 USCS 409A (a)(2)(2005). Regarding major changes in ownership of company, the IRS allows an NQDCP sponsored by a corporation (not a partnership) to grant the corporation discretion to terminate the plan and distribute the deferred compensation within 12 months of a change in control. 409A provides a detailed definition of change in control, which includes most sales, but not initial public offerings. *See* 26 USC 409A (a)(2)(A)(v)(2005); IRS Notice 2005-1, 2005-2 I.R.B. 274, Q&A 11-14 (Jan. 10, 2005).

<sup>24</sup> IRS Notice 2005-1, 2005-2 I.R.B. 274 (Jan. 10, 2005).

<sup>25</sup> *See* 26 USC 409A (a)(3)(2005).

<sup>26</sup> The term “key employee” has the meaning set forth in Code 416(i), which generally includes officers earning in excess of \$130,000, 5% owners, and 1% owners earning in excess of \$150,000 (except that it does not include key employees’ beneficiaries).

<sup>27</sup> *See* 26 USC 409A (a)(2)(B)(i)(2005).

<sup>28</sup> IRS Notice 2005-1, 2005-2 I.R.B. 274, I (B) (Jan. 10, 2005).

<sup>29</sup> *Id.*

- If an arrangement permits an employee to defer compensation beyond the exercise or disposition of the option, it will be subject to 409A, even if at fair market value on the grant date.
- A SAR will not be subject to 409A if the exercise price is not less than fair market value on grant and cannot become less than that amount, the stock of the recipient is traded on an established securities market, only that specific stock can be delivered in settlement of the SAR upon exercise, and the only deferral feature is postponing income until the employee exercises the right.

### **What is not Subject to 409A?**

The good news is that some compensation and benefit plans are not affected by 409A. Restricted stock that does not contain an additional deferral is not subject to 409A; but restricted stock units are, though they generally do not present adverse tax consequences. Employees can still take advantage of short-term bonus deferrals, but only if the bonus is paid within 2 1/2 months after the tax year in which the deferral is no longer subject to forfeiture. Tax-qualified employer plans, such as qualified retirement plans, tax-deferred annuities, simplified employee pensions (SEPS) and SIMPLEs, are not subject to 409A.<sup>30</sup> Moreover, NQDC plans do not include sick leave, vacation pay, compensatory time, disability benefits, death benefits, or medical and dental plans.

### **Severance**

The IRS aims to encompass plans that essentially disguise a deferred compensation benefit. Accordingly, some severance benefits may be treated as deferred compensation, depending on the terms of the arrangement. Severance plans that lack a permitted payment trigger, that permit acceleration or deferral of payments, that permit rabbi trusts to pay out severance benefits, or that give employees a choice between lump sum or continuous payments and their timing, are now subject to the new rules.

Under the proposed regulations, severance arrangements are not treated as deferred compensation under 409A if the separation pay is paid a) pursuant to a collectively bargained agreement and b) pursuant to a window program, or due to an involuntary termination of service where the amount of the separation is limited to the lesser of (i)

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<sup>30</sup> IRS Notice 2005-1, 2005-2 I.R.B. 274, Q&A 4(d) (Jan. 10, 2005).

two times the employee's annual compensation for services provided to the employer during the calendar year preceding the year in which the employee leaves the company or (ii) two times the maximum amount of compensation that may be taken into account under a qualified retirement plan (\$220,000 for 2006) under Code §401 (a)(17).<sup>31</sup> These separation payments must be paid out no later than December 31 of the second calendar year after the year in which the employee leaves the company.<sup>32</sup> The same time period is permitted for payment of reimbursements that are otherwise not included in an employee's gross income, such as moving expenses and medical expenses; this type of reimbursement is limited to specific amounts and restricted periods.

Notwithstanding these criteria, any payments made as a result of an involuntary separation within 2 ½ months after the end of the taxable year in which the employee's separation occurred ("the short term deferral rule) will not be treated as deferred compensation, even if the amount exceeds the two-times- the-lesser-of equation.<sup>33</sup> On the other hand, if the severance is paid as salary continuation payments that extend past the 2 ½ month period, or if the severance is paid on account of a voluntary termination (including resignation for "good reason"), the payments will be treated as deferred compensation under 409A. Despite the narrow exceptions, with proper planning most severance payments can be structured to comply with 409A by insuring that the payments are made according to a fixed schedule, are controlled by the employer, and can be modified (as that term is defined in the regulations) only to comply with 409A requirements (including those pertaining to "key employees" as described below).

Notably, all payments upon separation are aggregated for 409A purposes. For example, retention payments, compensation subject to accelerated vesting at separation, and bonuses and salary due upon separation will be aggregated to determine the two-times-the-lesser-of threshold. Therefore, many employees, particularly executives and middle managers, may exceed that threshold. In such circumstances, the employee could be

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<sup>31</sup> Prop. Tres. Reg. 1.409A-1(b)(9)(ii).

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

assessed the 409A excise tax, unless the payments are made within the short-term deferral time or pursuant to a compliant severance plan.

Under 409A, “key employees” at public companies, who separate from employment, cannot receive distributions earlier than 6 months after the date of separation. This requirement was not delayed by the proposed regulations and became effective on January 1, 2006.<sup>34</sup>

While the full impact of 409A on stock options and SARs is beyond the scope of this article, note that extensions or renewals of certain stock rights (often seen in employment and severance agreements) generally will be treated as adding deferral features to outstanding grants, thereby causing them to be subject to 409A. An exception applies, however, if the employee is prevented by securities laws from exercising such options during an otherwise permissible period because of a particular corporate transaction.

Attorneys representing employees in negotiating employment and severance agreements should advise their clients that severance payments must comply with 409A. Any plan or agreement that defers payment of severance or that allows flexibility in the timing or form of the payment should be avoided, or should be limited to the short-term deferral rule.

### **A Warning about Good Reason**

Treasury Department and IRS attorneys have long been suspicious of “resignation for good reason” clauses in employment agreements because they believe high-level executives manipulate such arrangements to cause NQDC to be paid as severance.<sup>35</sup> Typically, “good reason resignations” are triggered when an employee’s compensation, duties, responsibilities, or authority have been materially diminished, or when the employer materially breaches the terms of the employment relationship. In essence, the

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<sup>34</sup> Prop. Treas. Reg. 1.409A-1(i)(2).

<sup>35</sup> Paul, Hastings, Janofsky & Walker, LLP, News Center, New Code 409A and Severance (Summer 2005), <http://www.xpay.net/409Aseverance.htm> (last visited September 12, 2005).

employee is forced to resign (i.e., a “constructive dismissal”), thereby triggering severance and other benefits.

To control this perceived abuse, the proposed regulations “do not treat the right to a payment upon separation from service for “good reason” as a right “subject to a substantial risk of forfeiture.”<sup>36</sup> Unless the regulations are changed before becoming final, such separation payments will be subject to 409A compliance.<sup>37</sup> Oddly, for “key employees” of public companies (who must wait six months before receiving any separation pay), they cannot comply with 409A in the event of any resignation – even for “good reason” – because they must wait six months before receiving any separation pay. In this situation they will be subject to tax penalties. This peculiar result may help prevent “key employees” from deferring taxes; but it also will preclude all employees from entering into employment agreements that protect their rights to severance and other benefits if they are constructively dismissed. Without “good reason” resignation as an option, an employee’s only choice would be to resign and sue the employer for breach of contract.

Attorneys representing employees should ensure that the involuntary termination and the “resignation for good reason” provisions in agreements are separate and provide separate conditions and payment schedules. A Treasury Department representative has stated, that including a “good reason” clause in the same paragraph and context as termination without cause in a plan document or agreement could “poison” all the elements of a severance package; the reasoning appears to be that, if you combine a “good reason” resignation clause with an involuntary termination clause, you cannot determine when the right to severance payment vested, so the entire payment violates 409A.<sup>38</sup>

### **Be Careful What you Ask For**

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<sup>36</sup> Prop. Treas. Reg. 1.409A-II(G)(3).

<sup>37</sup> *Id.*

<sup>38</sup> The Treasury is still taking comments from the public on the issue of “good reason.” The final regulations may differ from the proposed regulations.



In this brave new world, an attorney representing employees in connection with employment and separation agreements -where new or pre-existing- must be alert to 409A issues. The attorney might urge the client to obtain professional advice from a lawyer or accountant familiar with the rules.

An attorney should analyze any promise to pay compensation (e.g., a short or long term bonus) that can be paid to the employee more than 2 ½ months after the end of the year in which the payment vests. Any equity (or phantom equity) plan that is not qualified and that is designed to defer compensation in an open-ended or flexible way is suspect. The attorney should suggest alternative arrangements and should bargain for compensation and benefits that will be compliant, assuring that the employee receives comparable value under the new compensation award. For example, discounted options could be replaced with a combination of new options at fair market value and a cash incentive bonus for the difference.

A current employee should ask the employer what has been done to comply with 409A in existing plans and might ask for conforming modifications. Attorneys for employees can counsel their clients on how best to approach the subject with the employer.

Whenever doubts exist about whether plans and agreements comply with the new rules, the employee's attorney should ask the employer to indemnify the employee for any taxes or penalties resulting from non-compliance. A less aggressive approach would be to ask the employer to warrant and represent compliance with 409A. If an employer is reluctant to do so, the employee considering a new position should question whether to sign the agreement or take the position.

Compliance with 409A is in an early stage. For now, the IRS is looking for good faith compliance from employers until final regulations are issued and audit personnel are trained. This presents an opportunity for employees' attorneys to collect evidence of good faith negotiation of these issues and due diligence by the employer. Written correspondence and emails between the employer and the employee regarding 409A

compliance may be persuasive evidence in an IRS audit. Finally, all agreements should be in writing.

### **Conclusion**

Although many of these changes regarding deferred compensation were directed at a small population of “key employees,” the effect has been much broader. Most other employees are unprepared to deal with these sweeping changes and the possible repercussions. While the cost of compliance is high for employers, the monitoring of such compliance will be borne by the employee as well. Thus, employees’ attorneys must be vigilant to guard against serious adverse tax consequences for their clients and at the same time protect their contractual rights. Ultimately, attorneys representing these employees will face greater responsibility and unexpected challenges.

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