



PROSKAUER ROSE LLP

# 409A Overview For Labor & Employment Attorneys

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# Section 409A Overview: The Big Picture and Key Concepts

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# IRC § 409A – What is it?

- Section 885 of the American Jobs Creation Act amended the Internal Revenue Code to add Section 409A, effective January 1, 2005.
- Under new Code Section 409A, all amounts deferred under a nonqualified deferred compensation plan or arrangement are includible in a taxpayer's current gross income to the extent not subject to a substantial risk of forfeiture (if not previously included in gross income), unless the deferred compensation plan or arrangement contains certain specified restrictions on elections and distributions and is operated in accordance with those restrictions.
- Legislative reaction to perceived abuses in the area of nonqualified deferred compensation arrangements.
- Broader impact vs. Legislative intent.

# Purpose

- Outgrowth of post-Enron era.
  - Sarbanes-Oxley visits tax “reform”
- Effort to control executive compensation and regulate compensation.
- Revenue driven
  - Tightening up IRS treatment of receipt of exec compensation
  - Prevents “pushing off” the receipt of income, matching the tax consequence to the period when income actually “earned.”
- Corporate “class warfare” issue from IRS’ perspective.

# The 409A Deferred Compensation Rules

- Code Section 409A significantly changes rules concerning nonqualified deferred compensation arrangements – Final regulations issued April 2007 (Law passed in 2004, previously IRS issued a series of Notices and Proposed Regulations)
- Extremely broad application
- Dictates timing of payments
  - Statute designates permissible payment events
  - General prohibition on acceleration of distributions
- Mandates timing of deferral elections
  - Initial elections
  - Subsequent elections
- Prohibits offshore rabbi trusts and financial health triggers

# Application of Section 409A

- Employment agreements and severance arrangements (safe harbor)
- Option Issues/Equity Arrangements
- Change in control agreements
- 401(k) wrap plans/plans tied to qualified plans
- Bonuses
- Retention plans
- Mergers & Acquisitions
- Private Equity
- International Plans

# Effective Dates

- 409A applies to “amounts deferred” after December 31, 2004
- Pre-2005 deferrals are grandfathered if earned and vested prior to 2005
  - Pre-2005 deferrals are subject to 409A if the plan is “materially modified” after 10/3/04
- Operational “good faith” compliance during transition period (1/1/05 – 12/31/08); certain transition relief continues to be available through 12/31/08 (Notice 2007-86)
- Final regulations are effective April 17, 2007 (but must follow by 1/1/09)
- Full documentary compliance by 12/31/08

# Why Comply?

- Adverse tax consequences for Employee for failure to comply
  - early income inclusion (for current and prior deferrals)
    - deferrals are taxable unless the compensation is subject to a “substantial risk of forfeiture” or previously included in participant’s gross income
  - 20% additional tax on amount required to be included in income
  - Penalty interest (underpayment rate plus 1%)

## Why Comply? (cont'd)

- Tax liability generally imposed on service provider (individual) – generally, not on employer (or other “service recipient”)
- However, employer has income tax withholding (but not 20% portion) and reporting obligations
- Need to comply in operation and in form

# Plan Aggregation Rules

- In general, all deferred compensation plans (for a single employee) within the same category of plan are treated as a single plan/penalties apply on a “single plan”/aggregated basis
- Final regs: 9 new categories of plans:
  - Elective account balance plans
  - Non-elective account balance plans
  - Non-account balance plans
  - Plans that pay out solely on involuntary separation or under a window program
  - Plans that provide in-kind benefits or reimbursements of expenses
  - Split-dollar life insurance plans
  - All plans providing stock rights that are not exempt from Section 409A
  - Arrangements under which deferred amounts would have been treated as modified foreign earned income if paid when first deferred
  - Other

# What is a “nonqualified deferred compensation plan”?

- Broad definition of “nonqualified deferred compensation plan”
- Need to identify plans subject to 409A and those exempt (but which may need periodic review)
- Deferral of compensation exists only if under the relevant facts and circumstances participant has a “legally binding right” during a taxable year to compensation that is or may be payable in a later tax year
- “SROF” – substantial risk of forfeiture

# What is a “nonqualified deferred compensation plan”? (cont’d)

Examples of deferred compensation:

- Voluntary employee-paid deferred compensation (deferrals of salary/bonus)
- Employer-paid deferred compensation
- Excess benefit plans
- SERPs
- Options and SARs (stock appreciation rights) granted with below-market exercise price or not based on “service recipient” stock or with an additional deferral feature
- Certain RSUs, bonus arrangements, severance, change in control agreements and payments such as severance under individual employment agreements

# What is a “nonqualified deferred compensation plan”? (cont’d)

- Excludes:
  - Qualified employer plans (e.g., ESOP, profit sharing, 401(k), pension, 403(b) or 457(b) plans (457(f) plans are covered)
  - Bona fide vacation, sick leave, compensatory time, disability pay or death benefit plans
  - ISOs
  - 423 employee stock purchase plans
  - Nonqualified stock options or SARs granted with FMV exercise price, no additional deferral feature and granted on “service recipient” stock
  - Restricted stock (§83 property)
  - Certain stock appreciation rights
  - Short-term deferrals
  - Profits interest in a partnership

# Short-term Deferral Exception

- Helpful (and probably most common) exemption from 409A
- Deferred Compensation does not include an amount that must be paid within 2½ months after the later of:
  - the end of the service provider's taxable year in which amount is no longer subject to substantial risk of forfeiture
  - or
  - the end of the service recipient's taxable year in which amount is no longer subject to substantial risk of forfeiture
- Final regs clarify that STD exemption is not available where plan provides that payment will or may be made outside of the STD period
- Impact on six month "specified employee" delayed payment period

# Service Providers

- 409A applies to deferred compensation paid to all service providers, including:
  - employees
  - directors
  - independent contractors
  - partners
  - personal service corporations  
(or similar noncorporate entities)
- General exception for accrual basis taxpayers

# Written Plan Requirement

- At the time an amount is deferred, the plan must specify the amount the employee has a right to be paid (or an objective, non-discretionary payment formula) and the payment schedule or payment triggering events (amend with specificity)
- Except as explicitly provided in the regulations, the plan need not specify the conditions under which a permitted accelerated payment may be made
- “Savings clauses” are disregarded in determining whether a deferred compensation plan is compliant
- Multiple documents may together satisfy requirement

# Timing of Payments

- Permissible 409A Payment Events: Deferrals may be paid only upon:
  - separation from service (as defined) (six-month delay for “key employees” of public companies)
  - death
  - disability (as defined)
  - a specified time or pursuant to fixed schedule specified at the deferral date
  - change in control (as defined)
  - unforeseeable emergency (as defined)
- Acceleration of payments prohibited
  - Acceleration of vesting permitted
  - Other exceptions (e.g., domestic relations orders, payment of employment taxes, certain plan terminations and liquidations).

# Fixed Date

- May use calendar year as a “fixed date”
- If a specified date (rather than an calendar year) is used, payment cannot be made earlier than 30 days before the specified date but can be made at a later date within the same taxable year of the employee or, if later by March 15 of the next year if employee is not given election as to the taxable year of payment
- Deadlines for payment permitted if the period during which the payment may be made is restricted to:
  - A specified taxable year or
  - A period of not more than 90 days, and the employee is not given an election as to the taxable year of payment

# Deferred Compensation Election Rules

- Election Rules
  - deferral elections
  - elections regarding time and form of payments
- Initial election:
  - must be made in the calendar year prior to year in which services are performed (exception for performance-based compensation based on at least 12 months or longer service period: must elect 6 months before end of service period, provided that compensation is not “readily ascertainable”)
  - must be within 30 days after participant becomes eligible to participate
  - elections for non-calendar year employers

# Deferred Compensation Election Rules (cont'd)

- Subsequent election:
  - cannot take effect until at least 12 months after date of election;
  - must provide for an additional deferral for at least 5 years (for elections related to payments other than due to death, disability or unforeseeable emergency; also apply separately to each payment event where multiple payment events); and
  - if related to payment at a specific time or pursuant to a fixed schedule, must be made at least 12 months prior to the date of the first scheduled payment

# Additional Prohibitions

- Prohibition on use of Offshore Rabbi Trusts: Deferrals held in an offshore trust or “similar arrangement” will be included in individual’s gross income
  - applies regardless of whether assets are available to satisfy claims of general creditors
  - exception for employees who perform substantially all of services in foreign jurisdiction in which trust is located
- Prohibition on Financial Health Triggers: Income inclusion where nonqualified deferred compensation plan provides that assets will be restricted to the provision of benefits upon a change in the employer’s financial health
- Same penalties for failure to comply

# Equity Compensation Issues

- Equity Based Compensation plans may involve 409A compensation deferrals
  - Restricted Stock – no deferral when restriction lapses
  - Restricted Stock Unit Plans – deferral if delivery of the shares is deferred after the right vests
  - Options and SARS – can result in deferral once exercisable

# Equity Compensation Issues

- Application of 409A to Options/SARS
  - Incentive Stock Options are not subject to 409A
  - Nonqualified Options and SARS not subject to 409A if:
    - Granted at FMV or higher
    - Number of shares is fixed
    - No other income deferral feature
    - Tied to “eligible service recipient stock”
  - Use of Equity of Entities Below Service Recipient an Issue
- Valuation Issues
  - Public companies – plans should specify how exercise price is determined
  - Private companies – reasonable application of reasonable valuation method
    - Presumption of Reasonableness (Qualified Independent Appraiser, Early Stage Written Valuation, Non-Lapse Restriction Valuation)
    - Notice 2006-4 (May provide more flexibility prior to 01/01/09)

# Equity Compensation Issues

- Application of 409A to Options/SARS – Modifications
  - Changes in terms may result in new grant and application of 409A
  - Acceptable changes
    - Acceleration of vesting
    - Adding certain cash-less exercise procedures
    - Grantor exercising discretion regarding transferability
    - Reducing exercise window following termination
    - Tolling exercise window under limited circumstances
    - Extending exercise period through to original term date
    - Re-pricing to fair market value
  - Prohibited changes
    - Direct or indirect reduction in exercise price
    - Adding any deferral feature

# Operational Compliance Issues

- Effective date of the final regulations is extended to January 1, 2009
- In 2008 plans must be operated in compliance with the provisions of Section 409A and with applicable provisions of Notice 2005-1 and other generally applicable guidance.
- To the extent an issue is not addressed in such guidance, plans must be operated consistent with a reasonable, good faith interpretation of Section 409A
- An employer must amend plan documents no later than December 31, 2008 to comply with Section 409A
- Parties may not rely on Proposed Regulations after December 31, 2007 (except for certain sections of the Preamble)

# IRS Notice 2007-100 (12/03/07) Guidance on Corrections of "Certain Failures" to Comply with 409A

- Transition and guidance regarding two types of "unintentional operational failures" to comply with 409A
  - No relief for plan "terms and provisions" that fail to meet 409A requirements and applicable guidance
  - Type I- Applies to "corrections" of "operational" failures "**in the same taxable year as the failure occurs**"—under same year "fix it" approach, 409A taxes avoided
  - Type II- Applies to operational failures prior to 1/1/10, and that are not fixed in the same year (but by end of second taxable year of service provider following year of failure), so long as amounts do not exceed \$15,500 (e.g. 401 (K) elective deferral levels). Correction in this type of failure involves payment of 409A tax on wrongfully paid amount, but not on entire deferred compensation arrangement.
  - Additional limitations apply to correcting erroneous payments during six month specified employee period (e.g. service recipient cannot have experience financial downturn putting otherwise timely payment to executive at risk)
- Examples of Type I "inadvertent operational failures" and "corrections"
    - Under/over deferral of annual bonus- Executive makes timely election to defer 50% of \$100,000 bonus in 2008 and only 10% is deferred--is corrected if by end of 2008, Executive pays employer \$40,000 and same amount is credited to Executive's deferral account. (Similar approach if Executive elects to defer 10% and 50% is inadvertently deferred)
    - Inadvertent payment to "specified employee" during six month period following separation from service- Executive repays the amount back to service recipient and service recipient legally commits to then make payment back to Executive after expiration of "erroneous holding period," measured from the later of the six month 409A payment date or the Executive's repayment date
    - Resetting the exercise price on an in-the-money option at time of grant, in the same year of grant, to the FMV of the stock, so long as the initial exercise price resulted from an "unintentional administrative error" in determining stock value

# Reporting Requirements

- Yearly deferrals (plus earnings) under a plan subject to 409A that are not includible in income because the plan is in compliance with 409A
  - IRS has not suspended the information reporting obligations for 2008 as it had done in the past for 2005, 2006 and 2007
  - For non-employee/independent contractor: Form 1099-MISC, Box 15a
  - For employees or former employees: Form W-2, Box 12 (Code Y)
- Reporting of amounts deferred that are includible in gross income due to 409A violation
  - Compensation deferred under the plan for the taxable year and all preceding taxable year is includible in gross income for the taxable year to the extent the 409A deferred compensation is not subject to a substantial risk of forfeiture and has not been previously included in gross income

# Reporting Requirements (cont'd)

- For non-employees or independent contractors
  - Form 1099-MISC, Box 7 and Box 15b
- For employees or former employees
  - Form W-2, Box 1 and Box 12 (Code Z)
  - Form 941 (Employer's Quarterly Federal Tax Return), Line 2
  - The amounts reportable are treated as "supplemental wages" for purposes of determining the appropriate withholding amount under Section 3402. Withholding is only applicable to 409A amounts includible in gross income, not on the tax penalties or interest related to such amounts.
    - Total supplemental wages is greater than \$1M, the withholding rate is 35% (or the highest income tax rate for that year)
    - Total supplemental wages is less than \$1M, withholding rate is 25%
    - Employees should note that estimated tax payments may be necessary to avoid penalties under Section 6654
    - Employer may be subject to penalties for failure to timely deposit the 2008 withholdings
- All service providers must report as income and pay any taxes due relating to amounts includible in gross income under 409A (Form 1040)

# Year End Action

- Notice 2007-86
  - Extends to 12/31/08 deadline to adopt plan document, that fully complies
  - Covered arrangements must be operated in full compliance with Regulations beginning on 1/1/09
  - Decide whether or not to take advantage of payment election transition relief (Notice 2007-86)
  
- Suggested Action Items
  - Establish 409A team or taskforce
  - Identify arrangements affected by 409A
  - For public companies, identify “key employees”
  - Assess compliance with 409A
  - Discuss and execute required changes

# Top 10 409A Issues For Labor & Employment Attorneys

1. "Specified Employee"/6-month payment delay for top 50 employees of public company
2. 409A Indemnification Provisions
3. Equity Grants/Repurchases/Modifications
4. "Separation From Service"
5. Documentary Compliance
6. Short-term Deferral Rules
7. Good Reason/Involuntary Termination/Specified Employee
8. Different Payment Schemes for Same Event (Toggle)
9. Substantial Risk of Forfeiture
10. Reimbursements/In-Kind Benefits



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