DEFERRED COMPENSATION ARRANGEMENTS -- A PRIMER FOR CORPORATE COUNSEL

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Introduction

The American Jobs Creation Act of 2004 (the "Act") introduced a new set of rules for "non-qualified deferred compensation plans." By adding Section 409A to the Internal Revenue Code, the Act subjected these very popular and common arrangements to a series of fairly restrictive new requirements regarding the timing of elections to defer compensation, distributions from covered arrangements and the use of so-called "Rabbi Trusts."[1]

Failure to satisfy these new requirements can lead to draconian tax consequences for the employee:

- Tax will be due on the amount deferred in the year in which the compensation is earned and vested (regardless of whether the employee is entitled to receive a payment in that year).
- An additional tax of 20% on the amount deferred also is imposed.
- "Interest" must be paid at the underpayment rate plus 1% on the amount of the underpayment of tax that would have occurred had the deferred compensation been included in gross income for the tax year of the deferral or, if later, the tax year in which the deferred compensation is no longer subject to a substantial risk of forfeiture.

For taxpayers in the top federal tax bracket, the minimum federal tax burden will equal 59.6%. If the deferral occurred several years in the past, the federal tax burden may easily be much higher.

Section 409A became effective as of January 1, 2005. By December 31, 2008, every non-qualified deferred compensation plan in existence at the time should have been identified, reviewed for compliance and, if necessary, amended to comply with Section 409A or any applicable exception. While many employers made substantial efforts to meet these requirements in a timely manner, due to the broad scope of Section 409A, some employers continue to find agreements or plans that were overlooked in the initial process.

The principal purpose of this paper is to provide a relatively high level overview of the requirements of Section 409A. The rules are not dealt with in detail, but the common types of arrangements that are potentially covered by the rules are identified and a very general overview of the applicable requirements is provided.[2]

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[1] These new requirements apply to arrangements with employees, independent contractors and other service providers. This paper focuses on arrangements with employees.

[2] This paper does not address the application of these rules to equity compensation plans.

Identifying Non-Qualified Deferred Compensation Plans

Section 409A reaches far beyond the commonly recognized forms of deferred compensation plans. The final regulations define the term “non-qualified deferred compensation plan” as any plan that provides for the deferral of compensation. Under the final regulations, a plan provides for the deferral of compensation if under the terms of the plan an employee acquires in one year a legally binding right to compensation that will or could be paid in a later year. The term “plan” includes not only arrangements covering multiple employees, but also agreements or arrangements with a single individual. In this paper, the term “plan” is used in a similar manner to refer to plans or arrangements covering multiple employees as well as individual agreements or arrangements.

Due to the sweeping reach of Section 409A, the first challenge facing an employer is simply to identify all of its non-qualified deferred compensation plans. Applying the definitions set out in the regulations, the following typical arrangements fall within the reach of Section 409A:

- Supplemental non-qualified savings plans.
- Supplemental non-qualified retirement plans.
- Employment agreements that provide for a deferral of compensation or severance pay.
- Change of control agreements.
- Severance plans (subject to important and helpful exceptions).
- Phantom stock plans.
- Stock appreciation rights plans (subject to certain exceptions).
- Restricted stock unit plans.
- Discounted options.
- Annual or long-term incentive plans that provide for a deferral of the payout.
- Settlement agreements (but an exception is available for bona fide settlement agreements that do not replace existing arrangements that are subject to Section 409A).
- Retiree medical arrangements (subject to certain exceptions).
- Indemnification agreements (subject to a broad and helpful exception).

Several types of programs may be disregarded. For example, a non-exclusive list of the more common types of programs that are expressly excluded from the reach of Section 409A includes the following:

- Qualified retirement plans (such as 401(k) plans, profit sharing plans, and traditional retirement or pension plans).
- Certain foreign plans.
- Restricted stock or other restricted property currently transferred in connection with the performance of services.
- Stock options granted at fair market value.
- Stock appreciation rights that are issued at fair market value and meet certain other requirements.
- Vacation or sick leave programs.
- Compensatory time programs.
- Disability pay.
- Death benefit plans.
- Archer medical savings accounts.
- Health savings accounts.
- Any other medical reimbursement arrangements satisfying the requirements of Section 105 or Section 106 of the Internal Revenue Code.
- Settlements of bona fide legal claims for wrongful termination, employment discrimination, etc., unless the settlement is replacing existing rights that are subject to Section 409A.

In a large organization, identifying all of the contracts and other programs that may fall within the reach of Section 409A may prove to be quite a challenge.

Plan and Agreement Review

All plans, agreements or other arrangements that were not previously reviewed for compliance with Section 409A should be reviewed for potential Section 409A issues by experienced in-house or outside counsel. The first stage of the review should focus on whether the plan, agreement or other arrangement is subject to Section 409A or otherwise qualifies for an exception to the requirements of Section 409A. Many agreements (such as indemnification agreements, expense reimbursement arrangements and other common agreements) can be dealt with easily. Other arrangements will require a slightly more detailed analysis to assure that the short-term deferral exception or the separation pay exception (both of which are described below) is available. Still others will require fairly significant amendments to comply with the full set of Section 409A requirements. Use of correction programs offered by the IRS also may be advisable.

Exception for Short-Term Deferrals

The final regulations include a very helpful "short-term deferral" exception. Essentially, Section 409A will not apply if the arrangement between the employee and the employer ***at all times*** requires payment no later than the end of the so-called "short-term deferral period," which ends 2½ months following the close of either the employee's or the employer's tax year in which the right to the compensation vests.

The short-term deferral exception will save many common programs from the reach of Section 409A.

For example, as long as the payments are made by the end of the short-term deferral period, the typical incentive compensation (or bonus) program that calls for the payment of a bonus shortly following the end of a fiscal year will not be subject to Section 409A unless employees are allowed to defer the payment of the bonus to a later year. While the short-term deferral exception should shield these arrangements from the reach of Section 409A, certain minor amendments are advisable to protect against the situation in which, for one reason or another, the bonus is not paid by the end of the short-term deferral period.

Similarly, certain severance plans or the severance provisions in an employment agreement may avoid the reach of Section 409A if the severance pay is paid in one lump sum shortly following an involuntary termination of employment. The same analysis will apply to change of control agreements that call for payments in one lump sum shortly following termination.

On the other hand, without proper planning, a severance or change of control arrangement may easily fall within the scope of Section 409A. For example, if a severance or change of control arrangement calls for payments over a period of time rather than in one lump sum, the full payments may not be made by the end of the short-term deferral period. If payments extend beyond this period, and if the severance or change of control arrangement does not satisfy the separation pay exception described below, Section 409A will be applicable.

Similarly, many severance and change of control arrangements permit an employee to terminate employment and receive payments if the employee is constructively discharged or, in the vernacular of many agreements, has "good reason" to terminate employment. The final regulations pave the way for the availability of the short-term deferral exception, even if the arrangement includes a "good reason" or constructive termination provision, as long as the definition complies with standards set out in the regulations. The good reason definition must require a material negative change in the employment relationship and, importantly, must include an opportunity for the employer to remedy the condition. The final regulations also provide a "safe harbor" definition of good reason.

Separation Pay Exception

The final regulations also include useful exceptions for separation pay arrangements. One exception is available for collectively bargained arrangements. A separate, more generally applicable, exception is available for non-collectively bargained arrangements and window programs that meet the following requirements:

- The arrangement may only provide payments in the event of an "involuntary" separation from service.

- The payments must end by the close of the second calendar year following the year of separation from service.

- The payments must be limited to an amount that is equal to the lesser of two times the employee's annual rate of compensation or two times the limit specified in Section 401(a)(17) of the Internal Revenue Code for the year in which the employee separates from service (2 x $255,000 for 2013).

As noted, the separation pay exception only applies in the case of an "involuntary termination." If under any circumstances (e.g., disability) separation pay will be due following a voluntary separation, the exception is unavailable.

Many severance arrangements permit an executive to voluntarily terminate employment for "good reason" and receive severance pay. The final regulations permit voluntary "good reason" terminations to be treated as involuntary separations as long as the "good reason" definition complies with the final regulations.

Employers often allow employees to resign rather than be fired. Under the final regulations, whether a particular termination is voluntary or involuntary is determined on the basis of all the facts and circumstances, provided that the parties' characterization of the termination will be presumed to be correct. This presumption can be rebutted by showing that absent a voluntary separation the employee would have been fired.

Even if the total severance payments exceed the two times limit mentioned above, amounts up to the applicable limit (*e.g.*, $510,000 in 2013) can qualify for the separation pay exception. Only the excess over the limit (*e.g.*, $510,000 in 2013) will be subject to Section 409A. This provision is extremely important for certain officers and shareholders of a publicly held company who may not receive any payments until six months following their separation from service. These individuals may receive up to the applicable limit during this initial six-month period, assuming the other requirements for the separation pay exception are met. (Note that the excess also might be excluded from the reach of Section 409A if the short-term deferral exception is available.)

Severance arrangements often provide that the employee will be entitled to continue to be reimbursed for certain expenses following separation from employment. The separation pay exception included in the final regulations permits medical reimbursements only as long as the employee would be entitled the coverage under COBRA. Another section of the regulations permits the reimbursement of medical expenses for an unlimited period (although this reimbursement must be analyzed under the new healthcare reform rules). The reimbursements for the medical expenses beyond the COBRA period must comply with the requirements of Section 409A (*i.e.*, these reimbursements do not qualify for the separation pay exception).

The final regulations also exempt from Section 409A any separation pay up to a certain limited amount ($17,500 for 2013).[3]

409A Requirements in General

If no exception is available, the arrangement must be reviewed against the requirements of Section 409A. As mentioned, Section 409A imposes new rules regarding the timing of elections to defer compensation, distributions from covered arrangements and the use of Rabbi Trusts. Section 409A also generally bans any acceleration of payments, regardless of whether the acceleration is at the election of the employee or the employer. A very general explanation of these requirements follows.

Elections to Defer Compensation

As a general rule, an individual must elect to defer compensation before the beginning of the calendar year in which the compensation is earned. An election, once made, is irrevocable. An exception applies for the year in which an employee is first eligible to defer compensation. A second limited exception is available if the compensation is subject to a substantial risk of forfeiture.

For performance-based compensation with a performance period of 12 months or more, the election must be made at least six months before the end of the performance period.

Distributions in General

A non-qualified deferred compensation plan that is subject to Section 409A may only permit distributions in the following limited circumstances:

- Distributions are allowed in the event of "separation from service," which is a term of art defined in the regulations. For a "specified employee" (generally any officer and certain significant shareholders of a publicly traded company), however, the distributions must be postponed for six months following separation from service.

- Distributions also are permitted following death or disability (as "disability" is defined in the regulations).

- Distributions may be made at a specified time or pursuant to a fixed schedule set at the time the compensation is deferred.

- Distributions may be made in the event of an unforeseeable emergency (as defined) beyond the employee's control.

- Distributions also are allowed within a limited period of time in the event of a "change of control." The "change of control" definition included in the final

[3] Another exception, the "stock rights exception," is helpful in the context of certain equity compensation arrangements.

regulations is much more restrictive than the definitions typically included in change of control agreements or plans.

Elections to Defer Distributions

Generally, if a non-qualified deferred compensation plan permits an employee to elect between various distribution options, the election must be made when the compensation is first deferred. Subsequent elections to change the initial selection are permitted only if the following requirements are met:

- Any change in the timing or form of the distribution must not take effect until at least 12 months after the election date.
- Except for payments on account of death, disability or unforeseeable emergencies, the distribution must be deferred for at least five years from the originally scheduled payment date.
- An election to defer fixed payment deferrals (distributions that are to be made at a specified time or pursuant to a fixed schedule) must be made at least 12 months before the first scheduled payment.

Timing of Payments

The final regulations include a series of exceedingly technical rules dealing with the timing of payments under an arrangement subject to Section 409A.

Under the final regulations, a payment will be deemed to be made on the scheduled date if it is paid not earlier than 30 days before the scheduled date as long as the employee is not permitted to select the taxable year of payment. The final regulations also allow a plan to designate an entire calendar year, rather than a specific date, as the specified payment date. Under the final regulations, if a plan provides only for a calendar year of payment (*e.g.*, the calendar year following an employee's separation from service), the payment may be made at any time during that year.

Deferred compensation arrangements often provide that a payment will be made as soon as administratively possible following separation from service, but no later than a particular date (for example, the end of the short-term deferral period). Under the final regulations, this approach is not permissible, unless the period during which the payment may be made is restricted to a specific calendar year or the period is not more than 90 days and the employee cannot elect in which year the payment is made.

The preamble to the final regulations specifically indicates that a payment scheduled to be made within 180 days of separation from service violates 409A because it does not specify the calendar year of payment and exceeds the 90-day period required by the final regulations.

Tax Gross-Ups

Tax gross-up payments may comply with Section 409A if made by the end of the calendar year following the year in which the related taxes are paid and certain other requirements are satisfied.

Reimbursements

Under the final regulations, a right to reimbursement may satisfy Section 409A as long as certain requirements are met. Perhaps the most important form of reimbursement arrangement relates to medical expenses. Under the final regulations, medical expenses may be reimbursed for an unlimited period of time. On the other hand, limitations may be imposed on the reimbursement of medical expenses.

The Use of Rabbi Trusts

Rabbi Trusts will continue to be used to informally fund various forms of deferred compensation arrangements. The use of offshore Rabbi Trusts, though, will result in immediate taxation.

Change of control agreements and non-qualified deferred compensation plans sponsored by publicly held companies often call for Rabbi Trust funding in the event of a change of control. Section 409A provides that a deferred compensation arrangement may not call for formal or informal funding due to changes in the financial health of the employer. In interim guidance, the IRS and Treasury seemingly took the position that this provision also precluded Rabbi Trust funding triggered by a change of control. The final regulations do not address this issue.

Ban on Acceleration of Payments

Subject to several exceptions, payments may not be accelerated, regardless of whether the acceleration is at the insistence or request of the employee or the employer. For example, many deferred compensation arrangements presently provide that the amounts due to an employee may be accelerated and paid early at the option of the employer. These provisions are no longer permitted. One of the more important exceptions permits the acceleration of payments following the termination of a plan if certain requirements are met.

Grandfathered Plans

Section 409A generally is effective with respect to amounts deferred after December 31, 2004. Section 409A does not apply to amounts that were “earned and vested” as of December 31, 2004, unless the plan is “materially modified” after October 3, 2004. A plan is materially modified if any existing benefit or right provided under the plan is enhanced, a new benefit or right is added, or a new plan is adopted.

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