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Employee Benefits | A Littler Mendelson Newsletter

Final Section 409A Regulations Affect a Wide Range of Compensation Devices and Require Employer Action by Year-End

By Steven J. Friedman

Long-awaited final Treasury regulations under Section 409A of the Internal Revenue Code ("Section 409A") were issued on April 10. These regulations govern nonqualified deferred compensation arrangements and are very broad in scope. They affect not only traditional executive compensation and equity compensation arrangements but also compensation devices that employers may not consider deferred compensation. These include severance arrangements, severance plans, deferred payments under employment agreements, annual bonus payments, long-term incentive arrangements and settlement agreements upon a termination of employment.

The final regulations are effective January 1, 2008 and require arrangements subject to Section 409A that are not currently in compliance with the rules to be amended by December 31, 2007. The penalty for noncompliance is an additional tax imposed on the employee. The tax equals 20% of the deferred compensation which is included in income (plus interest) as a result of noncompliance. Employers may be subject to tax withholding and reporting penalties.

This publication summarizes some of the areas where the final regulations made changes to the existing rules. We have covered those portions of the rules which we feel will have the greatest relevance to our clients. Littler will be publishing a more in-depth analysis of these rules shortly.

Also, because of the importance of these rules and the vast scope of the arrangements affected, Littler will be presenting a series of webinars/seminars across the country to educate our clients and friends regarding the steps necessary to be taken to ensure compliance with the final regulations.

Basic Section 409A Requirements

Under Section 409A, any arrangement that provides for the payment of compensation in a year later than the year in which the compensation was earned may be considered a deferred compensation arrangement subject to Section 409A.

- A deferred compensation arrangement must provide, at the time the arrangement is established, the form of the distributions to be made (e.g., lump sum or installments) and the timing of distributions. Distributions may commence at a fixed date or upon an employee's separation from service, death, disability, change of control or unforeseeable emergency.
- An employee election to defer compensation must meet certain requirements. It generally must be made in the calendar year prior to the calendar year in which compensation is earned. However, special deferral timing rules relate to an employee's initial eligibility to participate as well as deferrals of "performance based" compensation.
- "Specified employees" of publicly traded companies who trigger a payment of deferred compensation on account

of their separation from service cannot receive deferred compensation until six months following their separation date.

Exclusions: Qualified Plans, Fringe Benefits, and Certain Plans of Schools, Governmental Units, Churches, and Tax-Exempt Organizations

The section 409A rules do not apply to certain plans. Among these exclusions are:

- Plans qualified under Code section 401(a), such as 401(k) plans;
- Annuity plans under section 403(a);
- SEP or SIMPLE IRA plans under sections 408(k) or (p);
- Bona fide vacation, sick leave, compensatory time, disability or death benefit plans;
- Annuity contracts of educational institutions, churches and tax-exempt charitable organizations under section 403(b); and
- Eligible deferred compensation plans of governmental employers and tax-exempt organizations under section 457(b).

Governmental employers and tax-exempt organizations may exceed the limits and requirements of a section 457(b) plan by establishing a non-eligible plan under section 457(f). A non-eligible plan, or the non-eligible portion of a 457(b) plan, must meet the requirements of both section 457(f) and section 409A regulations. All other non-qualified deferred compensation plans of governmental, tax-exempt, church and church organizations must also comply with the section 409A regulations.

Provisions of the Final Regulations

Separation From Service

Issues can arise with respect to determining whether an employee who terminates employment and continues to work either as a part-time employee or independent contractor is "separated from service." The proposed regulations required that both compensation and service before and after the termination be compared.

- The final regulations clarify that a separation from service will be presumed to occur when there has been a termination of employment and any subsequent service by the individual, as either an employee or independent contractor, does not exceed 20% of the service performed over the last 36 months. Conversely, there is a presumption that no separation has occurred if the level of continued service is 50% or more.
- The final regulations provide additional flexibility by permitting an employer to designate, at the time compensation is initially deferred, a specific percentage of service between 20% and 50% that shall serve as an alternative threshold percentage. Note that if an employer adopts an "umbrella" document (see discussion below), this is a likely area to be included.
- The regulations continue to provide for a facts and circumstances analysis such that continued full salary and benefits could lead to a finding that there has been no separation from service, even if the service level would create the presumption that there was a separation.

Short-Term Deferrals

Short term deferrals are payments of compensation that are not considered deferred compensation because they are paid out by the 15th day of the third month following the tax year in which the payments became vested.

- The final regulations broaden the use of this rule by permitting an employer to designate a series of payments as separate payments. This permits the first payment or payments to be paid during the short term deferral period with others paid out as subsequent installments. This may be helpful with respect to specified employees who must otherwise wait six months to receive deferred compensation.
- The final regulations permit a payment to be delayed (with its eventual payment considered paid within the two and one-half month period) if payment would jeopardize the employer's ability to continue as a going concern or on account of unforeseen administrative impracticality.

Severance Pay Exception

Section 409A exempts certain separation pay arrangements from 409A applicability if the payments are made upon an employee's involuntary termination. In order to be exempted, the amount of the payments can be no more than the lesser of two times the annual pay or two times the Section 401(a)(17) limit ($450,000 for 2007), and all payments must be completed by the end of the second calendar year following the year of termination.

- Proposed regulations provided an "all or nothing" approach to this exemption whereby any amount that exceeded the dollar limitation would cause the entire amount to be outside of the exemption. The final regulations discard this all or nothing approach and apply Section 409A only to amounts paid in excess of the limit.

Involuntary Termination

The final regulations also provide greater clarity with respect to what constitutes an "involuntary" termination.

- "Good Reason" terminations (in which an employee leaves employment voluntarily after his or her employment is adversely affected) may be treated as an involuntary termination either under a "facts or circumstances" test or under a new safe harbor. Under the safe harbor, the good reason termination must result from a material diminution in duties, pay or authority or a material change in job location. The safe harbor requires there to be a 30-day cure period for the employer after the employee declares the existence of the good reason condition (and this declaration must be made within 90 days of the "good reason" event). Because this safe harbor is a departure from contractual language generally found in employment agreements, it is not clear how many employers will utilize the safe harbor.
- Where a termination is documented as a voluntary termination or a "mutual consent" termination, the final regulations provide that there will be a rebuttable presumption that the termination was voluntary. Other evidence, however, may overcome this presumption.

Settlement Agreements

Under prior guidance, it was unclear whether payments made under a bona fide settlement agreement would be viewed as deferred compensation, especially if all or a portion of the payout was not in dispute.

- The final regulations clarify that payments made in settlement of a bona fide dispute over the payment of deferred compensation will not cause a prohibited acceleration of deferred compensation to occur.
- The regulations provide that the dispute must relate to the amount of the payment, not just when a payment is due. Additionally, the regulations prohibit the use of this exception unless an employee would receive substantially less had there been no settlement agreement.
- The final regulations also provide that good-faith settlements of employment disputes do not constitute 409A-covered arrangements, so long as the settlement does not involve or waive claims to monies that would otherwise be payable under such arrangements.

Equity Compensation Provisions

Section 409A provides that stock compensation vehicles will be outside section 409A's reach if, among other things, an option or stock appreciation right ("SAR") is issued on "service recipient stock." The proposed regulations had restricted this exemption to options or SARs issued on the highest class of stock and, if an affiliate-employer had publicly traded stock, such stock had to be used.

- The final regulations broaden the definition of "service recipient stock" to include any class of stock and permit stock of an employer, parent or subsidiary to be used. The common stock used, however, cannot have any preferences other than a liquidation preference.
- In determining which corporations are in a parent-subsidiary chain, the regulations permit common 50% ownership (as opposed to 80%) to be used as the standard. A 20% threshold may be used if there is a legitimate business purpose to do so.
- The proposed regulations did not permit the post-termination extension of an option or SAR exercise period beyond the later of December 31 of the year of the original expiration date or two and one-half months after the original expiration date (without causing the stock right to be subject to Section 409A). The final regulations permit certain extensions of the exercise period for in-the-money options or SARs so long as the extension is not beyond the original term of the option or SAR and not beyond 10 years from the grant date. An "underwater" option can also be extended.

Plan Termination

The proposed regulations provided that an employer could terminate all deferred compensation plans of the same type and pay out all account balances without violating Section 409A if benefits were paid out between 12 and 24 months of termination and no similar plan was adopted within five years.

- The final regulations liberalize this rule by permitting a new plan after three years.
- Since all plans of the same type must be terminated, final regulations further facilitate the ability of employers to terminate plans by creating nine different categories of deferred pay plans (as opposed to four categories under the proposed regulations).

Determination of Specified Employees

Specified employees are those "key employees" who must wait six months after separation of service for payment of deferred compensation. Key employees are, among others, the top 50 officers in a corporation whose compensation is at least $145,000 (in 2007) per year. Under the proposed regulations, it was difficult to determine who was a specified employee, especially in a controlled group of corporations.

- The final regulations provide different options for employers to utilize in determining who are specified employees. Employers are specifically permitted, as a matter of convenience, to (i) include all employees as specified employees, (ii) include a "proxy group" of no more than 200 employees, or (iii) exclude foreign parents or subsidiaries.

December 31, 2007 Documentary Compliance Deadline

The regulations are effective January 1, 2008. Employers must be in good faith compliance with the regulations prior to such time, however.

- December 31, 2007 is the deadline for all documents to be amended to meet the requirements of section 409A. Noncompliant distribution provisions may be changed to provide 409A-compliant provisions so long as this does not cause amounts to be (i) deferred until a date later than December 31, 2007 if, in the absence of the amendment, payment would be made in 2007, or (ii) accelerated into 2007 if the amount would otherwise be payable at a later date.
- The final regulations permit employers to comply with section 409A by using more than one document for a single plan or payment. Thus, an employer can adopt "umbrella" documents that amend all plans of the same type or category, so that they will comply with section 409A. Note that if the umbrella document will amend a deferred compensation plan or employment agreements that require employee consent, the umbrella document will be subject to the signature acceptance of each affected employee.

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