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A Client Alert from Paul Hastings

The Final Word Under the New Section 409A Rules: Coverage

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Among many other things, the recently released final Section 409A Treasury Regulations (Final Regulations) clarify what types of arrangements are covered by Internal Revenue Code Section 409A (Section 409A).

IMPORTANT DEFINITIONS

Deferral of Compensation

A “deferral of compensation” occurs if a service provider subject to Section 409A acquires a legally binding right during a taxable year to receive compensation that is or may be payable in a later taxable year. A service provider does not have a legally binding right to compensation if the service recipient may unilaterally reduce the amount of compensation after performance of the services creating the right to the compensation.

On the other hand, a service provider may have a legally binding right to compensation even if the compensation may be reduced or eliminated by operation of the objective terms of the plan, such as a benefit formula or a substantial risk of forfeiture (SROF) provision (for example, a provision reducing payment if EBITDA thresholds are not met). Later in this Client Alert we discuss exemptions that may make Section 409A inapplicable to a deferral of compensation.

What’s New Under the Final Regulations

Amounts That “May Be” Payable in a Later Taxable Year Are Deferrals

The Final Regulations clarify that a plan provides for the deferral of compensation if an amount may be payable in a later year. For example, if the plan provides for payment on separation from service, it generally will provide for a deferral of compensation even if the service provider actually separates from service during the same tax year as the amounts are

earned, because it was possible that the individual would have remained employed until a future tax year.

Eliminates the Requirement That the Amount at Issue Not Be Actually or Constructively Received and Included in Gross Income

This change clarifies that a deferral of compensation occurs if a service provider makes an irrevocable election to defer compensation to a future taxable year, even if the service recipient pays that amount during the taxable year at issue. Such a payment normally would violate Section 409A, which generally prohibits acceleration of payments.

Nonqualified Deferred Compensation Plan

A “nonqualified deferred compensation plan” is any plan that provides for the deferral of compensation.

What’s New Under the Final Regulations

Time of Determination

The Final Regulations clarify that whether a plan provides for the deferral of compensation is determined at the time the service provider obtains a legally enforceable right to compensation under the plan. Thus, subsequent events that might otherwise satisfy an exemption are ignored.

Gotcha Provision

The Final Regulations provide that, if “a principal purpose of a plan is to achieve a result with respect to a deferral of compensation that is inconsistent with the purposes of Section 409A, the Commissioner [of the Internal Revenue Service] may treat the plan as subject to Section 409A.”

Plan

A “plan” is any agreement, method, program or other arrangement, including even one that applies only to a single person. A plan may be adopted unilaterally by the service recipient or may be bilaterally agreed to by the service recipient and one or more service providers. Section 409A’s requirements are applied as if a separate plan or plans are maintained for each service provider. The mere fact that a third party pays compensation to a service provider for services provided to a service recipient will not preclude the arrangement from constituting a “plan.”

What’s New Under the Final Regulations

For penalty purposes and for purposes of applying certain rules (such as the initial eligibility election and plan termination rules), plans of the same “type” maintained by the same service recipient that cover a service provider for which the service provider is eligible must be aggregated. Obviously, aggregation problems are inversely proportional to the number of plan “type” categories. Under the proposed regulations, four types had been recognized – account balance, nonaccount balance, separation pay and other. The Final Regulations add four additional categories and subdivide the account balance plan category into separate elective and nonelective types:

- (1) account balance arrangements attributable to elective deferrals;
- (2) account balance arrangements attributable to matching or nonelective deferrals;
- (3) in-kind benefit or expense reimbursement arrangements;
- (4) separation pay arrangements;
- (5) split-dollar life insurance arrangements;
- (6) stock rights;
- (7) arrangements deferring “modified foreign earned income”;
- (8) non-account balance arrangements not described in any of (3) through (7); and
- (9) any arrangement providing a deferral of compensation not previously described.

If a plan fails to comply with Section 409A’s requirements as to an individual, the failure will taint all other plans of the same type as to that individual because they will be aggregated with the bad plan.

Service Providers

The Final Regulations (along with prior guidance) refer to persons or entities potentially subject to Section 409A as “service providers.” Employees are the most common type of service provider. The Final Regulations clarify that the term “service provider” generally includes a former service provider.

Service Recipients

The Final Regulations (along with prior guidance) refer to the persons or entities for whom service providers work as “service recipients.” Employers are the most common type of service recipient.

SERVICE PROVIDERS SUBJECT TO SECTION 409A

General Rule

Section 409A generally applies to plans benefiting service providers, which include individuals, such as employees, directors, partners and proprietors, as well as corporations, S corporations, partnerships, personal service corporations or similar noncorporate entities. The Final Regulations exempt the following categories of service providers.

Exemptions

Accrual-Based Service Providers

The Final Regulations adopt the proposed regulation’s rule that Section 409A does not apply to legally binding rights extended to service providers who are using the accrual method of accounting (which individuals almost never use).

Most Bona Fide Independent Contractors

The Final Regulations provide an exemption from Section 409A coverage for payments or other rights extended to a person or entity (other than an employee or director) providing significant services to two or more recipients unrelated (as defined in the Final Regulations) to the service provider and each other. Whether services are significant is determined under a facts and circumstances test, with a safe harbor if the service provider’s revenues

from services to any service recipient (or group of related service recipients) are not greater than 70% of the total revenue the service provider generates from the applicable trade or business.

In addition, the Final Regulations provide a special look-back safe harbor for service providers that have been providing services in a trade or business for at least three consecutive years. This safe harbor applies for a tax year as long as (i) for the prior three tax years, the service provider satisfies the 70% test described above; and (ii) at the time of the deferral the service provider did not know or have reason to anticipate that the service provider would fail the 70% test for the relevant tax year.

Independent Contractors Working for Related Service Recipients

The Final Regulations include a new exclusion for independent contractors providing services to a related service recipient as long as (i) the independent contractor provides significant services to at least two service recipients that are not related to the independent contractor or each other (this means that the service provider must provide services to at least three service recipients) and satisfies either the general 70% test or the special three-year look-back safe harbor described above; (ii) the plan providing for the deferral at issue is a bona fide agreement, method, program or other arrangement with a related service recipient that arose in the ordinary course of the independent contractor's trade or business; and (iii) the plan described in subsection (ii) is substantially similar (including with respect to billing and collection practices) to another plan applicable to one or more unrelated service recipients to whom the independent contractor provides substantial services and that produce a majority of the total revenue that the independent contractor earns from the trade or business at issue during the relevant tax year.

Exclusion for Nondirectors

The Final Regulations clarify that the special exclusion for nondirectors applies to individuals holding similar positions with noncorporate entities that do not have directors.

PLANS TO WHICH SECTION 409A APPLIES, ABSENT AN EXEMPTION

General Rule

Absent an applicable exemption, Section 409A applies to a "nonqualified deferred compensation plan."

PLANS THAT ARE EXEMPT FROM SECTION 409A

Grandfathered Benefits

Section 409A does not apply to rights that accrued and vested prior to January 1, 2005 (including subsequent earnings), as long as those rights are not materially modified after October 3, 2004.

- The Final Regulations provide detailed rules for determining how much of a benefit is grandfathered, depending on whether the program is an account balance (generally the present value of the vested benefit as of December 31, 2004, plus earnings due solely to the passage of time), non-account balance (generally the vested balance as of December 31, 2004, plus earnings), or equity-based plan (generally the vested in-the-money amount as of December 31, 2004, plus earnings equal to the appreciation of the underlying stock or the accrual of other earnings, such as dividends). A plan can be entirely grandfathered (*e.g.*, because it was frozen before 2005), it can be partially grandfathered, or it can be wholly non-grandfathered.
- Although not necessary, to ensure that any changes made to non-grandfathered benefits will not inadvertently cause grandfathering to be lost for grandfathered benefits, employers should consider separating grandfathered benefits from non-grandfathered benefits through the use of separate plans.

What's New Under the Final Regulations

Nonaccount Balance Plans

The Final Regulations clarify that, for purposes of determining the present value of the grandfathered amount as of the payment date, reasonable actuarial assumptions and methods must be used and that, if an assumption or method was reasonable as of December 31, 2004, that same assumption or method will continue to be reasonable, regardless of the

then-current economic environment. Actuarial assumptions and methods that are used with respect to a qualified retirement plan that affect the amount of benefits under the nonaccount balance plan are presumed reasonable.

Account Balance Plans

The Final Regulations clarify that grandfathered benefits under an account balance plan include not only amounts deferred prior to January 1, 2005, but also later contributions that were accrued and vested as of December 31, 2004.

Material Modifications

The Final Regulations provide that the following are not material modifications:

- Establishing or contributing deferrals to a trust or other arrangement (*e.g.*, a Rabbi trust) from which benefits will be paid (as long as the contribution to that trust or arrangement does not otherwise cause the amount to be included in income).
- Modifying a provision that requires immediate cancellation of deferrals (*e.g.*, on account of a distribution because of a financial emergency), as long as the cancellation is for the same length of time and begins on the first date at which such a cancellation would not violate Section 409A.
- Complying with a domestic relations order (or amending a plan to require compliance with domestic relations orders).
- Modifying a plan to allow participants to choose between certain types of annuities.
- Modifying a plan to require or to allow the service recipient to require small benefit cashouts (as long as the entire amount under all plans of the same aggregation type is not greater than the Section 402(g)(1)(B) maximum – currently \$15,500). Any such modification (and exercise of service recipient discretion), however, must be accomplished in writing prior to the date of payment.

Exemption for Certain Tax-Favored Retirement Arrangements

Section 409A does not apply to any qualified retirement plan (under Internal Revenue Code Section 401(a)) or that would qualify under 401(a) if it had been created or maintained in the U.S., tax-exempt

annuity (under Section 403), SEP (under Section 408(k)), SIMPLE (under Section 408(p)), Section 501(c)(18) trust, any governmental excess plan described in Section 415(m), or any plan described in ERISA Section 1022(i)(2) (certain qualified retirement plans created or organized in Puerto Rico).

Exemption for Certain Welfare and Non-taxable Benefits

Section 409A does not apply to bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit (*i.e.*, one that only pays death benefits) plans, Archer Medical Savings Accounts, Section 223 Health Savings Accounts, or other nontaxable health reimbursement arrangements under Section 105 and 106. However, the Final Regulations clarify that changing a plan that provides for the payment of benefits on events other than death to one that only provides benefits on death will not take the plan out of Section 409A coverage.

What's New in the Final Regulations

Taxable Premiums

The Final Regulations clarify that the lifetime benefits payable under a disability pay or death benefit plan do not include the value of any taxable term life insurance or taxable disability insurance coverage under the plan.

Taxable Welfare Benefits

Although not an exception from Section 409A, the Final Regulations provide substantial relief by setting forth rules for how certain taxable benefits can be paid in order to satisfy Section 409A's distribution requirements. We will discuss these rules in depth in an upcoming Client Alert.

Payroll Periods That Span Tax Years

Section 409A does not apply to payments made to employees in the normal course during a payroll period (as described in Section 3401(b)) that spans tax years, or to similar payments to other service providers.

Short-Term Deferrals

Section 409A does not apply to a payment (that was not subject to a deferral election) that is actually or constructively made to a service recipient by the 15th day of the third calendar month following the end of

the later of the first taxable year of the service recipient or of the service provider in which the amounts are no longer (or not initially) subject to a substantial risk of forfeiture (SROF) (*i.e.*, the year in which the right to the payment became “vested”).

- For example, the short-term deferral exemption would apply to a contractual obligation to pay severance benefits in the form of a lump sum to an executive immediately after an involuntary termination of employment, that condition being an SROF.
- A payment that would have qualified for the short-term deferral exemption, but for the fact that it was paid too late, will qualify for the exemption if (1) it was administratively impracticable to pay the amount by the short-term deferral payment deadline, as long as the impracticability of making the payment timely was unforeseeable as of the date on which the legally binding right to the compensation arose, (2) making the payment by the deadline would have jeopardized the ability of the service recipient to continue as a going concern, (3) it is paid as soon as reasonably practicable or as soon as the payment would not jeopardize the ability of the service recipient to continue as a going concern. Although probable, it is unclear whether these rules can apply serially (*e.g.*, whether a payment that was delayed because it was impractical to make it by the deadline can be extended beyond the date it is practical to make the payment, if making the payment at that time would jeopardize the ability of the service recipient to continue as a going concern).
- Similarly, a payment that would have qualified for the short-term deferral exemption, but for the fact that it was paid too late, will qualify for the exemption if the service recipient defers the payment to avoid losing a deduction due to unforeseeable limitations under Section 162(m), as long as the payment is made as soon as reasonably practicable following the first date on which a deduction would be allowed under Section 162(m). It is unclear whether this special rule would apply to payments originally delayed for a non-Section 162(m)-related reason.
- It is not necessary that the arrangement specify in writing that the payment will be made within the 2½-month period, provided the payment is

actually made within that 2½-month period (as long as the arrangement did not specify a payment date or event that might be or is outside of the 2½-month period (*e.g.*, termination of employment). If payment is contingent on an event that may occur beyond the 2½-month period (*e.g.*, termination of employment), it will not qualify for the short-term deferral rule.

What's New Under the Final Regulations

Constructive Receipt

The Final Regulations clarify that an amount is actually or constructively received if it is includible in income, for example by application of Section 83, 402(b), 457(f), or the economic benefit doctrine.

Short-Term Deferral Exception Does Not Apply Merely Because Payments Are Made Before the Short-Term Deferral Deadline

As noted above, the Final Regulations provide that the short-term deferral rule does not apply if the plan provides that payment will be made or completed on or after any date or upon or after the occurrence of any event that will or may occur later than the applicable 2½-month period (*e.g.*, payment on separation from service, death, disability, change in control, unforeseeable emergency, etc.), even if the payment is made before the end of the short-term deferral period. For example, if an employment agreement provides that an employee will receive a lump sum severance benefit following the employee's termination of employment, the payment will not qualify as a short-term deferral.

Plans That Provide for Deferral Elections

The mere fact that a plan allows a service provider or service recipient to make a deferral election will not prevent the short-term deferral rule from applying if no election is made; rather, the rule's applicability is determined based on the payment date, schedule or event that would apply if no election were made. However, if the service provider or recipient in fact makes a payment election, the rule's applicability is determined based on the election.

Rule Applied Separately to Each Payment

The Final Regulations clarify that the short-term rule either applies or does not apply to each payment

under a plan individually, subject to the Final Regulation's rules as to what constitutes a payment (e.g., annuity payments generally are treated as a single payment). Thus, if any portion of the annuity payment will be made outside of the applicable 2½-month period, no portion of the payment will qualify for the short-term deferral rule after the end of the short-term deferral period. For example, if an employment agreement provides for 50% of a bonus to be paid on the lapse of a substantial risk of forfeiture and 50% a year later, the first payment would be eligible for the short-term deferral rule, but the second payment would not, even if it were accelerated and actually paid before the end of the short-term deferral period.

Jeopardize Solvency Exemption Changed to Jeopardize Ability to Remain an Ongoing Concern

The Final Regulations relax the special rule allowing payments to be made after the short-term deferral deadline if making them timely would jeopardize the service recipient's solvency to allow delayed payments if making them timely would jeopardize the service recipient's ability to remain an ongoing concern. The Final Regulations do not contain a special rule for delay made to satisfy loan covenants, but the preamble recognizes that violation of a loan covenant might qualify for this special rule.

162(m) Delay

The Final Regulations allow service recipients to delay payments on account of Section 162(m) concerns and still qualify for the short-term deferral rule. Under the prior proposed regulations, such a delay only would be permissible if the plan actually specified a payment date within the short-term deferral period.

Section 457(b) Plans

Section 409A does not apply to Section 457(b) plans or, to the extent they provide nonelective deferred compensation, to persons who are not employees under Code Section 457(e)(12). Length of service awards to volunteers under Code Section 457(e)(11)(A)(ii) are exempt from Section 409A.

Partnership Interests Issued in Exchange for Services

Until additional guidance is issued, grants of (or

options to purchase) a partnership interest (including a profits interest) in exchange for the performance of services is treated under the same principles that govern the issuance of stock (applying the principles applicable to stock options or SARs). Thus, their issuance is exempt from Section 409A to the same extent that it does not apply to the issuance of stock.

Partnership Distributions

Distributions to partners, including distributions that buy a partner out, currently are exempt from Section 409A, except for (1) certain Section 1402(a)(10) retirement payments to a partner, and (2) payments to a partner not acting in his or her partner capacity. Until further guidance is issued, the time and form of payment of Section 1402(a)(10) payments may be elected or established on or before the final day of the partner's taxable year immediately preceding the partner's first taxable year in which such payments are excludible from SECA tax under section 1402(a)(10). This is a new rule.

Separation Pay

Although Section 409A generally applies to deferred compensation payable on account of separation from service, the Final Regulations provide relief that generally will exempt most separation pay plans from Section 409A coverage. For a detailed discussion of Section 409A and separation pay plans, please see our upcoming client alert.

Foreign Plans/Foreign Compensation

The Final Regulations contain several broad-based exemptions for foreign plans and foreign compensation. We will examine these exemptions in an upcoming Client Alert dedicated to Section 409A's application to foreign plans and foreign compensation.

Tax-Equalization Agreements

Section 409A does not apply to grossed-up-for-tax payments that are limited to reimbursing service providers for foreign or U.S. taxes that cause them to pay more total taxes than if they were only taxed in the U.S. or a foreign jurisdiction, respectively, but only if the payments are made no later than the later of (1) the end of the second tax year of the service provider beginning after the tax year of the service provider in which the service provider's U.S. Federal income tax return is due for the tax year to which the tax equalization payment relates; or (2) the end of the

second taxable year of the service provider beginning after the latest such taxable year in which the service provider's foreign tax return or payment is required to be filed or made for the tax year to which the tax equalization payment relates. If the payments arise due to audit, litigation or a similar proceeding, the payments will not constitute the deferral of compensation as long as the payments are scheduled and made in accordance with the special rules relating to tax gross-up payments, discussed above.

What's New Under the Final Regulations

The Final Regulations expand the definition of tax equalization payments to include gross-up payments for the excess of the U.S. tax a service provider pays over that which the service provider would have to pay if only taxed in the foreign jurisdiction and clarify the timing requirements for payment.

Other Exclusions

The Final Regulations also exclude the following from Section 409A coverage:

- Indemnification rights, to the extent that the plan provides (insofar as allowable under applicable law) for the indemnification of (or the purchase of an insurance policy providing for payments of) all or part of the expenses or damages a service provider pays with respect to a bona fide claim against the service provider or recipient, including amounts paid to settle a bona fide claim, where the claim is based on action or inaction by the service provider in his or her capacity as a service provider to the service recipient.
- Legal settlements of bona fide employment claims based on wrongful termination, employment discrimination, the FLSA or workers' compensation statutes (along with claims under applicable law for attorneys' fees and costs). This exception does not apply to any deferred amounts that were not subject to a bona fide dispute.
- Taxable educational benefits (as defined in Section 127(c)) for the service provider (but not his or her family).



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