New Section 409A Creates New Rules Governing Nonqualified Deferred Compensation

Robert S. Schwartz

"Section 409A muscles its way into a large body of case law...."

SECTION 409A OF THE INTERNAL REVENUE CODE OF 1986 (the "Code") permits employees, independent contractors, and partners to defer the receipt and hence income taxation of all or some part of their calendar-year compensation, or for any 12 months or more, their performance-based compensation period compensation, but as strictly delimited by both section 409A and **in other rules set forth and** to be set forth in Treasury Regulations and other forms of guidance by the Internal Revenue Service (the "IRS"). For example, *see* Conference Report to H.R. 4520 (October 7, 2004) ("It is intended that Treasury Regulations will provide guidance regarding when an amount is deferred.")

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Section 409A itself, which was added to the Code by the American Jobs Creation Act of 2004, P.L. No. 108-357, section 885, 118 Stat. 1418,1634 (signed into law on October 22, 2004), is detailed and specific. A tax attorney can readily apply its specifics to the written, nonqualified deferred compensation plans deferring cash income receipts that have been widespread for the last 20 or so years. This can be done either by drafting a new plan or modifying (watch out) an existing plan and further advising clients as to the numerous new rules for section 409A administrative compliance. (All section references are to the Code unless otherwise indicated.)

However, the further removed are the deferred compensation fact patterns from these widespread cash deferred compensation plans, the more and more attenuated the application of section 409A becomes. In a figurative sense, section 409A muscles its way into a large body of case law, regulations, and IRS revenue rulings and procedures that to a considerable extent had settled the issues, and to some extent led to a more than decade-long stand-off between the IRS and the deferred compensation advisory industry. *See,* Rev. Rul. 60-31, 1960-1 C.B. 174, *mod~fled by* Rev. Rul. 64-279,1964-2 C.B. 121, and Rev. Rul. 70-435, 1970-2 C.B. 100; Rev. Proc. 71-19, 1971-1 C.B. 698; Rev. Proc. 92-65, 1992-2 C.B. 428. *See also,* section 132(a) of the Revenue Act of 1978, which provided: "The taxable year of inclusion in gross income of any amount covered by a private deferred compensation plan shall be determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1,1978."

The main subject of section 409A and this article is the timing of taxation of compensation yet to be actually received. Accordingly, this article reviews section 409A, its legislative history, IRS Notice 2005-1, 2005-2 I.R.B. 274 Qan. 10, 2005), and some of the important pre-section 409A legal history addressing the income tax treatment of various kinds of deferred compensation. For simplicity of analysis, I will most often refer to the "service provider," the "service recipient" and the "plan" as the subject matter of section 409A.

OVERVIEW OF SECTION 409A • Section 409A(a)(1)(A) provides that all "amounts" "deferred" for all taxable years under a nonqualified deferred compensation "plan" are nonetheless includable in gross income of the service provider to the extent the "amounts deferred" are not subject to a "substantial risk of forfeiture" and were not previously included in gross income, unless the plan meets the section 409A requirements. A deferred compensation plan must therefore incorporate the section 409A requirements from new plan starting dates or from the effective dates of section 409A for pre-existing plans.

Drawing upon the House and Conference Reports' descriptions of section 409A, Notice 2005-1, Q&A 4, states that compensation is "deferred" whenever a service provider possesses a legally binding right to compensation during a taxable year that has not yet been actually or constructively received by him and is payable to him in a later taxable year. There is no legally binding right, and hence no deferred compensation for purposes of section 409A, however, if the service recipient may unilaterally reduce or eliminate promised compensation, unless such power is illusory. Substance is to prevail over form says the Notice. Objective plan provisions that operate in ways that might reduce or eliminate the deferred compensation are not considered service recipient unilateral rights. For two reasons, therefore, amounts of compensation may be "deferred" under plans that might re-

duce or eliminate the deferred compensation. Confused? Read on.

Section 409A(d)(3) defines the term "plan" as "any agreement or arrangement, including an agreement or arrangement that includes one person," involving deferred receipt of compensation amounts. Drawing upon the House and Conference Reports' descriptions of section 409A, Notice Q&A 9 adds that a plan "includes any agreement, method or arrangement, including an agreement, method or arrangement that applies to any one person or individual." A "method" seems to extend to conscious ideas, inconsistently and informally put into practice, or simply the modus operandi, of closely held business owners periodically deciding to defer portions of their salaries to future years.

Notice 2005-1 expressly avoids detailed discussion of the very important meaning and application of the "amounts" deferred covered by section 409A. There is some discussion of the meaning of the term in the Notice. (See discussion of Q&A 17, *infra.)* Further guidance should be issued during 2005.

Deferred cash plans, NQOs, SARs and similar deferred compensation plans are subject to section 409A. Usually, NQOs, SARs and similar nonqualified, non-cash plans involve the presence of a "substantial risk of forfeiture." Therefore, section 409A defers income inclusion of deferred amounts until that risk goes away, but at that time, previously deferred amounts will become taxable under section 409A, unless the "plan" meets the section 409A requirements.

A critical question for plans, particularly for existing plans, is when exactly must the plan first meet the section 409A requirements: when compensation is first deferred, such as occurs when options have been granted at an exercise price below stock value on the grant date, or when the stock compensation received upon exerdse is no longer subject to a substantial risk of forfeiture, such as after 10 years from option grant when the option stock would no longer be forfeited upon termination of employment? The best answer the author reaches is when the compensation is first deferred, except that as to existing plans Notice 2005-1 grants time during 2005 for plan-conforming amendments.

Penalty For Noninclusion

Section 409A(a)(1)(B) provides that if compensation was required to be included in gross income under subparagraph 409A(a)(1)(A) for any earlier taxable year, but was not, the service provider's income taxes due under section 409A are increased by an amount equal to 20 percent of the deferred amount required to have been previously included in gross income, plus interest. (Notice 2005-1, Q&A 2, describes the 20 percent tax as an "additional income tax." This characterization clearly implies that the IRS has discretion to impose tax penalties, such as the 20 percent of the tax underpayment, accuracy-related penalty of section 6662, in appropriate situations.) Interest is set at the tax underpayment rate plus one percentage point, and is imposed on the income taxes that would have been incurred had the deferred amount been includable in income for the taxable year in which first deferred, or if later, the first taxable year such deferred amount is not subject to a substantial risk of forfeiture. In addition, the interest charge is imposed on the earnings on such improperly deferred amount in intervening taxable years. (Section 6621(a)(2), (b) provides for the rate of interest on income tax underpayments for any given year. The underpayment rate is the federal short-term rate for the first calendar month in each calendar quarter determined in accordance with section 1274(d), plus three percentage points. Section 6622(a) further provides that the amount of quarterly changing interest required to be paid on tax underpayments is compounded daily.) However, of some relief to taxpayers, clause 409A(a)(1)(A)(ii) provides, in ef-

fect, that not all participants in a given deferred compensation plan necessarily will be subjected to this special section 409A taxation, when a deferred compensation plan fails to meet the requirements of section 409A only with respect to any given participant. Only the offending participants' deferred compensation would be subjected to section 409A taxation in these circumstances.

Construing Section 409A

Section 409A(c) provides that, in effect, the courts shall not construe section 409A to prevent the inclusion of amounts in service provider gross income under any other provision of Chapter 1 of the Code (Normal [income] Taxes and Surtaxes) or under any other rule of law. In other words, section 409A is not to preempt the pre-section 409A body of law accelerating the timing of income taxation of deferred compensation. In the preamble to Notice 2005-1, the IRS, consistently with section 409A(c), states that section 409A does not alter or affect the application of any other provision of the Code of common law tax doctrines, such as the constructive receipt doctrine, which is contained in case law and Treasury Regulations, the cash equivalency doctrine, the economic benefit doctrine, the assignment of income doctrine, and section 83 of the Code. Thus, in section 409A Congress handed the IRS a formidable weapon to add to its existing weapons arsenal to be used against the deferral of income taxes on compensation

Notwithstanding the foregoing, section 409A legally might, and practically speaking probably will for tax counselors, preempt the field for the income taxation of deferred compensation for several reasons. The wording of section 409A(a)(1)(A) is so comprehensive and elemental that it appears to tax any non-forfeitable earned compensation not reported by service providers for the calendar year earned absent strict section 409A compliance. The courts should find it relatively easy to apply, as compared to their looking for ascertainable amounts at the time of deferral or tax avoidance motives or valid business reasons or the meaning of the constructive receipt doctrine or the appropriate scope of the cash equivalency and economic benefit doctrines, in light of the more fundamental rule of "realization of income." Moreover, the income taxes, plus the 20 percent tax, special purpose interest, and possible tax penalties and more interest that become due pursuant to section 409A are readily ascertainable enough that IRS 30-day or 90-day letters can be expected to focus on section 409A to the complete exclusion of the constructive receipt regulations or available legal doctrines. As though presaging this practical result, section 409A(c) further provides that any amount included in gross income under section 409A will not be required to again be included in gross income under the Code or any other rule of law. But then again, obviously, section 409A is no kind of safe harbor.

MORE SECTION 409A DEFINITIONS AND SPECIAL RULES • Section 409A(d) contains many definitions and special rules. Section 409A(d)(1) provides that section 409A applies only to so-called nonqualified deferred compensation. This means section 409A does not apply to "qualified" plans having the effect of deferring compensation, such as section 401(k) retirement plans available to private sector employees and section 457 eligible deferred compensation plans available to employees of governments and their agencies and instrumentalities. Section 409A(d)(1) further provides that section 409A does not apply to such specific welfare benefit arrangements as vacation, sick leave, disability income, or death benefits plans.

Notice 2005-1, Q&A3, adds Medical Savings Accounts and any health care cost reimbursement plans meeting sections 105 and 106.

Substantial Risk Of Forfeiture

Section 409A(d)(4) contains essentially the same definition of when deferred compensation is subject to a "substantial risk of forfeiture" as does section 83(c)(1) when a service provider's right to the property transferred in connection with the performance of services is no longer subject to "a substantial risk of forfeiture": whenever "such person's rights ... are conditioned upon the future performance of substantial services by any individual." The tie-in to section 83 is important because the section 83 regulations and case law and IRS ruling precedents are thereby made relevant to interpreting and applying section 409A(d)(4). ("The Code must be given as great an internal symmetry and consistency as its words permit. All sections of the Code must be read so as to be consistent with one another." *Commissioner v. Lester,* 366 U.S. 299, 304 (1961); *Huber v. Casablanca Industries, Inc.,* 916 R2d 85 (3d Cir. 1990).) That said, further elaboration in the Conference Report and Notice 2005-1 obfuscates the relevance of section 83 and its precedents.

For instance, the Conference Report emphasizes that if a deferred compensation plan's purported conditioning of the receipt of deferred compensation on substantial future services is illusory, the IRS (and the courts) are to go beyond the four corners of the plan for purposes of applying section 409A. The report uses as an example a fact pattern where an executive effectively controls the acceleration of the lapse of a substantial risk of forfeiture. Notice Q&A 10 addresses corporation fact patterns where the service provider is an owner of a service recipient having the power to prevent a substantial risk of forfeiture from materializing.

On the other hand, Q&A 10 further provides that a substantial risk of forfeiture also is present when compensation receipt depends upon the service recipient's business activities or organizational goals, such as a prescribed level of earnings, equity value, or a liquidity event. But any substantial risk of forfeiture that arises after the beginning of the service period to which the compensation relates, or any extension of a period during which compensation is subject to a substantial risk of forfeiture, in either case, whether elected by a service provider, service recipient, or any other person is not taken into account. Further, the Notice expressly disallows as qualifying risks the conditioning of receipt of deferred compensation upon refraining from performing services, i.e., a noncompetition covenant. Finally, an amount is not considered subject to a substantial risk of forfeiture beyond the date or time the service provider could have chosen to receive the amount, unless the amount subject to forfeiture is materially greater than the amount the recipient otherwise could have elected to receive. Thus, reductions of 10, 20, or even 50 percent are not materially greater than the amount a recipient otherwise could have elected to receive. Such smaller reductions, known as "haircuts" in the deferred compensation industry, are not countenanced by section 409(A).

Finally, according to the Conference Report, purported substantial risks of forfeiture are also to be disregarded when "used in a manner in consistent with the purposes of [section 409A]". Since section 409A(a)(1)(A) states "compensation...shall be includible in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture," it is impossible to read and comprehend or intuit the meaning of this circular logic imperative. Of course, as of yet, there is no case law expounding on meanings. So tax attorneys and IRS agents will have to wait and see.

SPECIFIC REQUIREMENTS FOR ALL PLANS SUBJECT TO SECTION 409A • Sections 409A(a)(2), (3), and (4) set forth three sets of requirements for all nonqualified plans deferring compensatory amounts. Plan failure to meet any one requirement, whether in the plan document or in operation of the plan, will cause all deferred compensation for a taxable year and all preceding taxable years, to the extent not otherwise previously included in gross income, to be includable in gross income for the later of the taxable year first deferred or the year of termination of non-illusory, and apparently circumscribed, substantial risks of forfeiture. The requirements easily fit with pre-section 409A cash deferred compensation plans as described at the beginning of this article. However, the further and further removed are the fact patterns from these kinds of deferred compensation plans, the more and more attenuated becomes the application of the requirements.

DEFERRAL ELECTIONS • Section 409A(a)(4) provides that compensation for services during a calendar year may be deferred at a service provider's election only if the election to defer is made not later than the close of the preceding year, except that:

- In the case of the first year in which a participant becomes eligible to participate in a plan, such election may be made with respect to income for services to be performed after the election date within 30 days after the date the participant becomes eligible to participate; and
- In the case of performance-based compensation based on services performed over any period of at least 12 months, such election may be made no later than six months before the end of the performance-based compensation period.

Section 409A(a)(4) also provides that previously deferred compensation may be further deferred by a service provider, whether or not for bona fide, nontax business purposes, provided, however:

- The election to further defer does not take effect until at least 12 months after the date made.
- The first payment with respect to which such further election is made must be deferred for a period of not less than five years from the date such payment would otherwise have been made, except accelerated payments of further-deferred amounts are allowed on account of disability, death, or the occurrence of an unforeseeable emergency.
- Any election to further defer which relates to payments as to which previously specified times or fixed schedules had been elected may not be made less than 12 months before the date of the first of the series of payments.

Thus, in the case of previously specified or scheduled deferrals, the election to push off receipt for at least five years must be made at least 12 months before the date of the first of the series of such payments.

Veit And *Martin* Overruled

Thus the well known case of *Veit v. Commissioner, 8 T.C.* 809 (1947), as well as the subsequent case of the same name found at 8 T.C.M. 919 (CCH) (1949), are overruled. In *Veit,* an employer and an executive entered into a deferred compensation agreement on January 2, 1939, pursuant to which the executive was to receive, on July 1 and October 1, 1941, 10 percent of the employer's net profits for 1939 and 1940. During November, 1940, the agreement was amended to further defer from 1941 until 1942 receipt of the not-yet-due or yet-ascertained 194010 percent net profit share. During June 1941, the year which under the unamended 1939 agreement the 1940 profits-based compensation was due, a second amendment set forth the ascertained 1940 profits to be paid during 1942 and exactly when during 1942. All

of the deferred compensation was unfunded and unsecured.

The IRS took the position that the 1941 amendment resulted in the executive's constructive receipt of the 1940 deferred compensation in 1941, because the amount of 1940 deferred compensation became ascertained during 1941, the same year the parties further amended the 1939 agreement. The Tax Court rejected the IRS argument on three grounds:

- The original deferred compensation agreement, the 1940 amendment, and the 1941 amendment were each bona fide, arm's length transactions;
- The 1940 amendment took place before the amount with respect to 1940 profits either was due (under the 1939 original agreement) or could be ascertained; and
- Although by June 1941 the 1940 profit-based compensation could be ascertained, the 1941 amendment deferred amounts not due until 1942 under the 1940 amendment.

If section 409A had applied to the *Veit* facts, the service provider would be taxed during 1941 on the 1939 and 1940 10 percent profit shares. See, section 409A(a)(4)

The well-known case of *Martin v. Commissioner,* 96 T.C. 814 (1991) is overruled. In *Martin,* an employer converted its old phantom stock plan, in which two executives had accrued deferred compensation benefits that became payable upon termination from service in 10 annual installments, to a new phantom stock plan that provided instead for lump-sum payout upon employment termination, unless the executives elected to receive payments in 10 annual installments. This conversion occurred during 1981; thereafter, also in 1981, the executives' employment terminated and they elected the 10-year payout under the new plan.

The IIZS argued that the plan conversion to a lump-sum payout, coupled with the executives' elections to instead take 10-year payouts and their employment terminations, all occurring during 1981, amounted to the constructive receipt of their old plan deferred compensation amounts during 1981. The Tax Court rejected this argument on several grounds:

- Both the old and new plans were unfunded;
- The deferred amounts were corporate assets;
- The employees' interests were not secured in any way;
- Their rights to receive payments continued to be subject to limitations and restrictions as of the plan conversion date;
- Under the plans an election out of a lump sum distribution in favor of installment payments could only be made before the deferred payments were due or were finally ascertainable in amount; and
- The overall nature of the continuing deferral transaction was bona fide, arm's length.

If section 409A had applied to the *Martin* facts, the service providers would be taxed during 1981 on their previously deferred amounts. Their new elections to defer did not take effect until at least 12 months after the election dates. The first payment with respect to which the new deferral elections were made was not deferred for a period of at least five years from the date such payment would otherwise have been made under the plan.

Distribution Times And Events

Section 409A(a)(2) provides that compensation deferred under a plan may not be distributed any earlier than a short list of times and events. A contextual analysis indicates all of these times and events must be contained in a written deferred compensation plan. Focusing on the service provider, the first is an employee's "separation from service" and the second the date "disabled." The third is death; the fourth is times specified or schedules fixed at

the date of original deferral; fifth, upon an unforeseeable emergency.

Focusing on the service recipient, the sixth is upon a change in ownership or effective control of the service recipient or in the ownership of a substantial portion of its assets. Notice 2005-1, Q&A 14(a), defines "substantial" assets as 40 percent of more of the gross fair market value of assets pre- change. All of these times or events for payments of deferred compensation are in substance if not exact wording very commonly found in pre-section 409A written deferred compensation plans. Congress further saw fit to specifically define "unforeseeable emergency" and "disabled" in section 409A. I do not repeat these definitions here. They are narrower than the hardship rules governing early withdrawals from 401(k) plans. In addition, Congress added that whenever a deferred compensation plan employee is a "key employee" (as defined in section 416(i) without regard to paragraph (5) thereof) of a publicly traded company, a plan must defer distributions upon separation from service for six months after the date of separation, unless the former key employee dies in the interim.

No Acceleration

Section 409A(a)(3) provides that a plan must bar acceleration of the time or schedule for payout of deferred compensation, except as may be provided in Treasury Regulations. Thus, as a general rule, once a service provider has specified the time or times or fixed a schedule for payouts, the provider is barred from electing to accelerate payout. In a broad sense this rule makes sense, because otherwise service providers could control the timing of recognition of previously deferred compensation. (Treas. Reg. §1.451-2 provides, in part, that gross income, although not actually reduced to a cash-method taxpayer's possession, is constructively received by him in the taxable year it is set apart for him or otherwise made available so that he may draw upon it at any time.) Thus, for example, it appears that when an original 2005 deferral election to take payout in 15 equal installments beginning in 2010 until 2025 is changed in 2008 to take payout in 10 equal installments beginning in 2015, there occurs no acceleration, only a delay in five years' worth of payments. On the other hand, if the payout is delayed five years until beginning in 2015, and is to be paid over five years ending 2020, five years' worth of payments are impermissibly accelerated.

However, nontax-motivated, business-driven situations can occur where the service recipient may desire or even be effectively forced to accelerate a deferred compensation payout, such as in a bankruptcy context. Hence, Treasury is given regulatory authority to grant exceptions to the statutory general rule.

Exceptions To No Acceleration

In Notice 2005-1, Q&A 15, Treasury provides a number of reasonable exceptions to the "no acceleration" rule. First, if a service recipient waives or accelerates the satisfaction of a condition constituting a substantial risk of forfeiture, such waiver or deemed satisfaction by the service recipient is not counted as a prohibited acceleration. A classic example is set forth: if a plan provides for a lump-sum payment of a vested benefit upon separation of service, and the benefit vests under the plan only after 10 years of service, it is not a violation of the no-acceleration rule if the service recipient reduces the vesting period to five years of service, even if the service provider becomes vested as a result and sooner qualifies for payment upon separation from service. The Notice **provides for other permissible acceleration events,** as follows:

- A domestic relations order in the context of divorce and support; in the event of a conflict-of-interest divestiture (as described in section 1043(b)(2), relating to officers and employees of

the executive branch of the federal government);

- For a plan subject to section 457(f), an acceleration of payment in order to pay income taxes due upon a vesting event under the plan, provided the amount of payment is not more than an amount equal to income tax withholding that would have been remitted by the employer through the IRS if there had been a payment of wages equal to the income includable by the participant under section 457(f) at the time of vesting;
- To pay FICA taxes imposed under sections 3101 and 3121(v)(2) on deferred compensation.

Additionally, acceleration of payment is permitted to facilitate withholding of income taxes at the source on wages imposed under section 3401 and to pay additional income taxes on wages attributable to any pyramiding of section 3401 wages and withholding taxes. The overall limit is the aggregate amount of FICA taxes and the income tax withholding.

Accelerated lump-sum final payouts are permitted under two other rules: if a service provider's interest in the plan has a value below an amount specified by the plan, then such person's entire interest under the plan may be distributed on an accelerated basis as a final lump-sum payment. For example, a plan may provide that no amounts of less than $25,000 may continue to be deferred by a service provider but shall be paid out as a lump sum upon a specified time or date. Second, a payment due not greater than $10,000 may be accelerated, provided the payment accompanies the termination of the entirety of the service provider's interest in the plan, the payment is made on or before the later _of December 31 of the calendar year in which occurs the service provider's separation from service, or the day two and one-half months after such person's separation *from* service.

OFFSHORE TRUSTS AND CHANGES IN FINANCIAL CONDITION OF SERVICE RECIPIENT • Section 409A(b) includes special rules limiting the use of trusts to hold deferred compensation amounts. The new rules affecting such trusts are relatively narrow in focus compared to the general thrust of section 409A and may be summarized as follows: under section 409A(b)(1), whenever a service recipient sets aside assets in a "trust" (or any trust-like arrangement) for purposes of its eventually paying deferred amounts, such assets will be treated as property transferred to the service provider in connection with the performance of services under section 83 "as of" the time set aside, if such assets or the situs of the trust or trust-like arrangement are located outside of the United' States or "as of" the time transferred if such assets (or trust or trust-like arrangement) are initially U.S. based but subsequently are shifted outside of the United States. This all means that during the calendar year of any such circumstances the assets (at their then value) are included in taxable income of the service provider.

Increases in the value of or any earnings on trust assets are taxed annually. Moreover, an additional amount equal to 20 percent of the amounts required to be included in gross income as described above also becomes due. Interest at the tax underpayment rate plus one percentage point is imposed "as if" the assets that had been set aside had been includable in income for the taxable year in which compensation with respect to those assets was first deferred (or if later, the first taxable year such assets were not subject to a substantial risk of forfeiture), and in addition, this interest is imposed on the increases in value and earnings on such assets as earned in subsequent taxable years post asset-set-aside or transfer off-shore.

Obviously, Congress is intent upon ending off-shore techniques in conjunction with de-

ferred compensation. The Conference Report emphasizes that these tough rules apply even if the assets remain available to satisfy the claims of the employer's general creditors. As tough as the rules are, Congress enacted a common sense exception: section 409A(b)(1) does not apply to assets located in foreign jurisdictions if substantially all of the services to which the deferred compensation assets relate are performed in such jurisdiction. These rules against foreign trusts obviously fit within the context of the bigger battle between the IRS and abusive tax avoidance through off-shore trust arrangements. (In 1996 Congress passed the Small Business Job Protection Act, PL. 104-188. This legislation dealt many legal blows to taxpayers' attempts to evade U.S. income and other taxes by placing income and assets in off-shore trusts and using other trust-like off-shore arrangements.)

Section 409A(b)(2) prohibits a deferred compensation scheme whereby deferred amounts become immediately available to plan partici pants or to trusts for their benefit upon "a change in the employer's financial health whether or not the deferred compensation is available to satisfy the claims of the employer's general creditors." This provision originated in Congress's becoming aware of a similar provision in the Enron executive deferred compensation plan.

STOCK OPTIONS, STOCK APPRECIATION RIGHTS, AND OTHER EQUITY BASED COMPENSATION • Section 409A does not mention, nor does section 409A(e) expressly delegate to the Treasury authority to make regulations extending section 409A to nonqualified stock options, stock appreciation rights, and other equity based deferred compensation plans.

Congress, as has now almost become routine, authorizes the Treasury to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section...." The Conference Report indicates Congress's intention that the term "nonqualified deferred compensation plan" include grants of options with an exercise price that is less than the fair market value of the underlying stock on the date of the grant. Beyond this limited reference in the legislative history, there is no wording that section 409A is to apply to compensatory receipts of stock options, stock appreciation rights, and other equity-based compensation. On the other hand, the Conference Report states that section 409A is not intended to change the tax treatment of incentive stock options meeting the requirements of section 422 or options granted under an employee stock option plan meeting the requirements of section 423.

Section 672 of the Senate amendment to H.R. 4520, which specifically addresses the income taxation of equity-based compensation such as stock bonuses and nonqualified stock options governed by section 83, and is suggestive of its application to stock appreciation rights, was not adopted by the Conference Report and was not enacted into law. It is interesting to note that this unpassed, proposed law has nevertheless found its way into Notice 2005-1. What kind of quality of rule of law is evident in this vignette? Not one that encourages those who are inclined to think the principle of rule of law is of enduring value.

Notice 2005-1's Rules

Notice 2005-1, Q&A 4(d), sets forth a general rule that the grant of a stock option, stock appreciation right, or any other equity-based com pensation, such as a restricted stock bonus, can include deferred amounts subject to section 409A. The Notice provides exceptions for incentive stock options described in section 422 and grants of options under employee stock purchase plans described in section 423. So-called

non-statutory stock options, which historically have been governed exclusively by section 83, are presumed by the Notice to create a deferral of compensation unless such options meet three conditions:

- The option exercise price "may never be less" than the fair market value of the underlying stock on the date of option grant (commonly found 15 percent discount options under prior law thus involve "deferral");
- The grant or exercise of the option is subject to taxation under section 83 (such section is very broad, covering all options other than 422 and 423 options); and
- The option does not have a readily ascertainable fair market value at the time of grant under Treas. Reg. 1.83-7, which point the Notice makes in this way: "the option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of the exercise or disposition of the option under [Treas. Reg.] 1.83-7."

The IRS states that if the exercise price "could become" less than the fair market value of the stock on the date of grant, the grant "may pro vide" for the deferral of compensation. The Notice provides that the right to receive substantially nonvested stock upon the exercise of an option does not itself constitute a feature for the deferral of compensation. For this purpose, stock is substantially nonvested when it is subject to a substantial risk of forfeiture within the meaning of Treas. Reg. 1.83-3(c) and is not transferable within the meaning of Treas. Reg. §1.83-3(d). The apparent purpose of this rule is to confirm that any increase in the value of the stock between the date of its acquisition through option exercise and when it later becomes vested does not implicate the section 409A requirements until the taxable year of vesting.

Under Q&A 17(c), the amount deferred as of December 31, 2004, in the case of equity-based compensation, equals the amount available to the participant that is then vested and earned. Thus, for a discount stock option, pursuant to which the stock upon exercise of an option is subject to a substantial risk of forfeiture such as a requirement to perform future services, or as to which options are unexercised on December 31, 2004, the account balance on December 31, 2004, is to that extent deemed to be 0.

In light of the foregoing, for pre-section 409A discount stock options, deferred amounts appear to be present from the discount option grant date until the option exercise date. (Section 83(b) elections appear irrelevant, notwithstanding that they are historically understood to lock in the compensatory element in exercised stock options.) Thus, the pre-2005 exercise of pre-2005 granted discount stock options under an unmodified plan should not be subject to the section 409A requirements. Post-2004 exercise of post-2004 granted discount stock options is subject to the section 409A requirements. Post-2004 exercises of pre-2005 granted discount stock options involve a feature for the deferral of compensation, since they were granted at a discount and the exercise takes place post-2004. One can infer from the Notice that this deferral feature continues across the pre- and post-January 1, 2005, general effective date of section 409A. Therefore, a pre-2005 stock option plan involving pre-2005 grants of discount stock options must conform to section 409A to avoid immediate section 409A taxation of post-2004 option exercises. Although the exercise itself does not involve a deferral feature if the stock is restricted (as discussed above), the deferral had already occurred by virtue of the discount element conclusively presumed to be present as noted. Therefore, it appears most desirable to freeze such a plan as to pre-2005 option exercises and adopt a new plan for post-2004 exercises which meets the section 409A re-

quirements. Alternatively, a plan can be amended during 2005 to comply with section 409A.

In addition, Q&A 17(d) provides that post-2004 increases in the amount of pay-out available under a stock option, stock appreciation right, or other equity-based compensation plan above the amount available as of December 31, 2004, due to the appreciation in the underlying stock after December 31, 2004, are treated as earnings on the amount deferred under the plan as of December 31, 2004. For discount stock options, post-2004 stock appreciation-related earnings on an account balance deemed to be 0 would likewise be 0.

Bonus Stock

The Notice leaves unsettled whether or not bonus stock or other compensatory receipts of property in kind are subject to section 409A or whether section 83 alone governs such compensation. Thus, Q&A 4(e) provides, in effect, that the receipt of property not includable in income under section 83 in the year of receipt by reason of the property being nontransferable and subject to a substantial risk of forfeiture, or which, alternatively, would be includable in income under section 83 due solely a valid election under section 83(b), does not itself involve the deferral of compensation. On the other hand, if the service provider obtains a legally binding right to receive property (whether or not the property is restricted property) in a future year, such right might involve a plan for the deferral of compensation. Thus, for example, when an executive obtains a promise of a grant of restricted bonus stock, there might be a deferral of compensation by virtue of the promise. Drafting a stock bonus or stock appreciation rights "plan" to comply with this possible section 409A deferred compensation in light of the specific requirements for plan inclusion under subsection 409A(a) would take considerable imagination.

Stock Appreciation Rights As Deferral?

Notice Q&A 4(d)(iv) addresses whether or not stock appreciation rights involve a plan for deferral of compensation. As in the case of nonstatutory stock options, a safe harbor of sorts is laid out. There is no deferral if:

- The value of the stock (where the right provides for payment of any excess over that value upon exercise) may never be less than the fair market value of the underlying stock on the date the right is granted;
- The stock of the service recipient subject to the right is traded on the established securities market and only such traded stock of the service recipient may be delivered in settlement of the right; and
- The right does not include any feature of deferred compensation other than the deferral of recognition of income until the exercise of the right.

As in the case of nonstatutory stock options, the right to receive substantially nonvested stock upon the exercise of stock appreciation rights does not constitute a feature for the deferral of compensation. On the other hand, the Notice further provides that if the exercise price could become less than the fair market value of the measuring stock on the date of grant, or the right might be settled upon exercise in a medium other than the traded stock of the service recipient, or there is an arrangement under which the service recipient will purchase stock delivered in settlement of exercise of the right, then the grant of the stock appreciation right might provide for deferred compensation.

BEYOND "EMPLOYEE" DEFERRALS • Section 409A does not use the terms "independent contractor," "personal service corporation," "partner," or "partnership," nor does it refer to or state that it may apply depending upon whether a service provider uses accrual, in con-

trast to the cash method accounting. The author cannot find these concepts implied in section 409A. The Conference Report, however, states: "The application of [section 409A] is not limited to arrangements between an employer and employee."

Concerning true independent contractor arrangements, Notice 2005-1, Q&A 8 provides that section 409A does not apply if a service provider is actively engaged in a trade or business of providing substantial services (and is not an employee or a director of a corporation) and provides services to two or more service recipients to which the service provider is not related and which are not related to one another. This appears as an exception, however. Thus, outside directors are not protected from section 409A. Q&A 8 at first provides that section 409A covers inter alia personal service corporations ("PSC") (*see* § 269A(b)(1)), but not when the PSC and the service recipient are accrual-method taxpayers. Thus, a director forming a PSC does not escape section 409A except by adopting accrual accounting, which ends deferral of fixed and determinable director fees anyway.

For now, Notice 2005-1, Q&A 7, provides that section 409A "may apply" to arrangements between a partnership and a partner which pro vide for a deferral of compensation, and advises that for now taxpayers may view by analogy the receipt of a partnership interest for services or of options to acquire partnership interests for services as receipts stock or stock options in applying the guidance in the Notice. This advisory makes a lot of sense for applying section 409A to publicly traded partnerships' deferred compensation plans.

However, typical partnership or joint venture agreements, as distinguished from customary deferred compensation plans involving em ployees and employers, don't (I've never seen them), for example, contain section 409A(a)(2)-type provisions in practice. In addition, apart from the application or potential for application of section 409A to capital or profits interests in partnerships received for services to partnerships, Q&A 7 states that section 409A may apply to payments for services to partners by partnerships other than in their capacity as partners. Such a partner is essentially in the same position vis-a-vis the partnership as an independent contractor would be to a service recipient. There is nothing special, therefore, about the partner status in this regard.

EFFECTIVE DATES OF SECTION 409A

Section 885(d) of the Act provides that section 409A shall apply to "amounts deferred" after December 31, 2004, and in addition, sets forth a number of complex special effective date rules.

First, section 409A applies to earnings on deferred compensation only to the extent that section 409A applies to such deferred compensation. This means that (subject to plan modification anti-abuse transitional rules) earnings on all amounts deferred before January 1, 2005, should not be subject to section 409A.

Second, section 885(d)(2)(B) provides that amounts deferred in taxable years beginning before January 1, 2005, shall be treated as amounts deferred in a taxable year beginning on or after January 1, 2005, assuming the plan under which the deferral is made had been materially modified after October 3, 2004, unless such modification was pursuant to specific guidelines. This means that for unmodified plans the previously stated effective date only is germane. A dear implication is that pre-2005 plans that are terminated or "frozen," and therefore are not subject to section 409A, should be distinguished from plans adopted after December 31, 2004, which would be subject to section 409A. The IRS has confirmed the validity of the "freeze-the-old-plan" approach in a conversation with the author.

In addition to the Act's effective dates, Notice 2005-1 itself devotes an entire section to effective dates and transitional relief guidance. Q&A 16(b) provides that an amount of compensation has been deferred before January 1, 2005, only if the service provider had a legally binding right to be paid the amount before such date and the right to the amount had been earned and vested before such date. Further, a right to an amount is earned and vested only if the amount is not subject to either a substantial risk of forfeiture or a requirement to perform further services. For this purpose, "a substantial risk of forfeiture" is such a risk as defined in Treas. Reg. §1.83-3(c).

Earnings Accumulated Before 2005

In addition, Q&A 17 specifically describes the methodology to be used in determining "the amount of compensation" and the "earnings" thereon accumulated before January 1, 2005. The IRS begins by distinguishing so-called account balance plans from nonaccount balance plans. The former are nonqualified deferred compensation plans that provide for crediting to an individual account of an employee-participant both the deferred amount and the earnings on such amount, and the benefits payable to such person are based solely upon the balances credited to the individual account. When these plan features are not present, the plan constitutes a nonaccount balance plan.

In the case of account balance plans, the amount of compensation deferred before January 1, 2005, equals the portion of the participant's account balance which as of December 31, 2004, had been earned and vested. Earnings on such amounts deferred before January 1, 2005, include income (whether actual income earned or notional earnings) attributable to such amounts post-2004. If a new plan is to be adopted for compensation deferred from and after January 1, 2005, separate accounting will need to be made of income earned on old plan amounts compared to income on new plan amounts.

Q&A 17 provides that the "amount of compensation deferred before January 1, 2005, in the case of a nonaccount balance plan, is to be determined as if a participant voluntarily terminated services without cause on December 31, 2004, and received the full payment of benefits from the plan on the earliest possible date allowed under the plan. The accrued amount is then present valued, if necessary, as of December 31, 2004. In addition, earnings attributable to pre-2005 deferred compensation in a nonaccount balance plan equal the present value of the future payments to which the service provider has a legally binding right, the present value of which constituted amounts deferred under the plan before January 1, 2005.

Material Modification

Q&A 18 addresses when a plan is materially modified from and after October 3, 2004. The significance is that a pre-January 1, 2005 plan materially modified after this date is subject to the section 409A requirements. However, paragraph (c) provides that amending a plan to stop future deferrals thereunder is not a material modification of the plan. It is not a material modification for a participant to exercise a right permitted under a plan as in effect on October 3, 2004. The reduction of an existing benefit is not a material modification. Similarly, stopping future deferrals under such a plan should not constitute a plan modification when deferrals are made pursuant to a newly adopted plan effective from and after January 1, 2005. The notice emphasizes a material modification to an existing plan occurs if a benefit or right existing as of October 3, 2004, is enhanced or a new benefit or right is added. This is so whether the enhanced or added benefit occurs pursuant to an amendment or a service recipient exercises discretion

under the terms of the plan, unless the exercise of discretion over the time and manner of payment of a benefit is provided under the terms of the plan as in existence on October 3, 2004. However, a post-2004 new plan subject to section 409A is a separate plan.

PRACTICE CHECKLIST FOR

New Section 409A Creates New Rules Governing Nonqualified Deferred Compensation

Section 409A permits employees, independent contractors, and partners to defer the receipt and hence income taxation of all or some part of their calendar-year compensation. Section 409A, which was added to the Code by the American Jobs Creation Act of 2004, is detailed and specific. However, the further removed are the deferred compensation fact patterns from historically widespread cash deferred compensation plans, the more attenuated the application of section 409A becomes.

• Section 409A(a)(1)(A) provides that all "amounts" "deferred" for all taxable years under a "nonqualified" deferred compensation "plan" are nonetheless includable in gross income of the service provider to the extent the "amounts deferred" are not subject to a "substantial risk of forfeiture" and were not previously included in gross income, unless the plan meets the section 409A requirements.

— A deferred compensation plan must therefore incorporate the section 409A requirements from new plan starting dates or from the effective dates of section 409A for pre-existing plans.

— A critical question for plans, particularly for existing plans, is when exactly must the plan meet the section 409A requirements: when compensation is first deferred, such as occurs when options have been granted at an exercise price below stock value on the grant date, or when the stock compensation received upon exercise is no longer subject to a substantial risk of forfeiture, such as after 10 years from option grant when the option stock would no longer be forfeited upon termination of employment? The best answer the author reaches is when the compensation is first deferred, except that as to existing plans Notice 2005-1 grants time during 2005 for plan-conforming amendments.

Section 409A(a)(1)(B) provides that if compensation was required to be included in gross income under subparagraph 409A(a)(1)(A) for an earlier taxable year, but was not, the service provider's income taxes due under section 409A are increased by an amount equal to 20 percent of the deferred amount required to have been previously included in gross income, plus interest. Section 409A(d)(1) provides that section 409A applies only to so-called nonqualified deferred compensation. This means section 409A does not apply to "qualified" plans having the effect of deferring compensation, such as section 401(k) retirement plans available to private sector employees and section 457 eligible deferred compensation plans available to employees of governments and their agencies and instrumentalities.

• Section 409A(d)(1) further provides that section 409A does not apply to such specific welfare benefit arrangements as vacation, sick leave, disability income, or death benefits plans. Notice 2005-1, Q&A3, adds Medical Savings Accounts and any health care cost reimbursement plans meeting sections 105 and 106.

- Section 409A(a)(4) provides that compensation for services during a calendar year may be deferred at a service provider's election only if the election to defer is made not later than the close of the preceding year, except that:

  In the case of the first year in which a participant becomes eligible to participate in a plan such election may be made with respect to income for services to be performed after the election date within 30 days after the date the participant becomes eligible to participate; and

  In the case of performance-based compensation based on services performed over any period of at least 12 months, such election may be made no later than six months before the end of the performance-based compensation period.

- Section 409A(a)(4) also provides that previously deferred compensation may be further deferred by a service provider, whether or not for bona fide business purposes, provided, however:

  The election to further defer does not take effect until at least 12 months after the date made.

  — The first payment with respect to which such further election is made must be deferred for a period of not less than five years from the date such payment would otherwise have been made, except accelerated payments of further-deferred amounts are allowed on account of disability, death, or the occurrence of an unforeseeable emergency.

  — Any election to further defer which relates to payments as to which previously specified times or fixed schedules had been elected may not be made less than 12 months before the date of the first of the series of payments.

- Section 409A(a)(2) provides that compensation deferred under a plan may not be distributed any earlier than a short list of times and events. A contextual analysis indicates all of these times and events must be contained in a written deferred compensation plan. Focusing on the service provider, the first is an employee's "separation from service" and the second the date "disabled." The third is death; the fourth is times specified or schedules fixed at the date of original deferral; fifth, upon an unforeseeable emergency.

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