

THE JOBS ACT’S HARSH NEW DEFERRED COMPENSATION RULES

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This article is part of a July 2005 update to the four-volume treatise *Mergers, Acquisitions, and Buyouts* by Martin D. Ginsburg and Jack S. Levin (cited in this report as *Ginsburg and Levin Treatise*).

In this article, the authors provide updated analysis of strict tax rules imposed on deferred compensation arrangements by the American Jobs Creation Act of 2004. The effect of the new rules is surprisingly broad and, although preliminary guidance provided by IRS Notice 2005-1 addresses some of the uncertainties created by the new rules, many important but unanswered questions remain. The authors provide a detailed description of how the new rules operate, illustrated with many examples, and identify many issues urgently in need of regulatory clarification.

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I. Introduction

The American Jobs Creation Act of 2004 (P.L. 108-357) (enacting Internal Revenue Code section 409A) imposes strict tax rules on a service provider’s nonqualified deferred compensation. The new rules:

- (1) impose current income inclusion plus harsh penalties (20 percentage points of additional tax, increasing an individual’s top federal tax rate from 35 percent to 55 percent, plus, in some cases, an interest charge) on deferred compensation not satisfying the strict section 409A requirements;
- (2) apply broadly to any arrangement deferring payment of compensation (including an equity-based arrangement such as a nonqualified stock option (NQO) that is in the money when granted or modified, a stock appreciation right (SAR), or a restricted stock unit);
- (3) do not apply to (a) compensation deferred under a qualified pension, profit-sharing, or similar plan or (b) a bona fide vacation, sick leave, disability, or death pay plan;
- (4) apply to employees, and in limited circumstances to independent contractors (for example, directors) and partners or LLC members;
- (5) impose strict rules for a service provider’s deferral election;
- (6) impose strict limitations on deferred compensation payment triggers; and
- (7) impose current income inclusion plus harsh penalties (20 percentage points of additional tax, plus, in some cases, an interest charge) if assets funding deferred compensation are set aside or restricted (or in certain circumstances required to be restricted) in a trust or certain other arrangements, even though still subject to general creditors’ claims.

Section 409A is generally effective for (1) an amount deferred after December 31, 2004, or an amount deferred before but not vested until after December 31, 2004, and (2) an amount deferred and vested before January 1, 2005, under an arrangement materially modified after October 3, 2004, unless modified in a manner permitted by IRS Notice 2005-1 (issued December 20, 2004, and clarified by

the IRS on January 5, 2005),¹ providing interim guidance on transition relief, discussed in Part VIII below.²

Thus, for example, section 409A applies to pre-January 1, 2005, deferrals of amounts that are subject to a substantial risk of forfeiture (SRF) that does not lapse until after 2004.³

Many of the complex rules discussed in this article are vague and poorly drafted, and application of the rules in many cases depends on fine distinctions among similar, but not identical, deferred compensation arrangements, so that determining tax consequences requires careful review of the arrangement and related facts.

Many of the complex rules discussed in this article are vague and poorly drafted, and application of the rules in many cases depends on fine distinctions among similar, but not identical, arrangements.

Section 409A is a dramatic example of socially motivated tax legislation (designed not to raise revenue but to discourage executives' deferral of compensation, enacted in response to the executive compensation abuses of the late 1990s) that adds tremendous uncertainty and complexity to the tax law, as described in this article. Other examples of needless tax complexity resulting from socially motivated tax legislation include (but certainly are not limited to) the golden parachute tax rules in sections 280G and 4999 and the \$1 million per year, per executive compensation limitation for a public corporation's top executives in section 162(m).

II. Deferred Compensation Definition

Compensation is potentially subject to section 409A penalties only if it constitutes "deferred" compensation. Based on the October 2004 legislative history, section 409A apparently adopts the definition of deferred compensation based on a presumption in a long-standing section 404 regulation, that is, compensation is "de-

ferred" if paid more than 2½ months after the end of the tax year in which the compensation is earned: "It is intended that [section 409A] does not apply to annual bonuses or other annual compensation amounts paid within 2½ months after the close of the tax year in which the relevant services required for payment have been performed."⁴

Notice 2005-1 further (and confusingly) elucidates this definition of deferred compensation:

Rule 1: "A plan provides for the deferral of compensation only if, under the terms of the plan and the relevant facts . . . , the service provider has a *legally binding right* during a tax year to compensation that has not been actually . . . [paid]⁵ and included in gross income, and that, pursuant to the terms of the plan, is *payable* to (or on behalf of) the service provider *in a later year*," and for that purpose an amount subject to an SRF is (despite the SRF) considered a legally binding right.⁶

Rule 2: "A deferral of compensation does not occur if, absent an election to otherwise defer the payment to a later period, at all times the terms of the plan require payment by, and [the] amount is actually [paid] . . . by, the later of . . . 2½ months from the end of [1] the service provider's first tax year in which the amount is no longer subject to [an SRF] or [2] . . . [the employer's] first tax year in which the amount is no longer subject to [an SRF]" (the 2½ month rule), and for that purpose, "an amount that is never subject to [an SRF] is considered to be no longer subject to [an SRF] on the date the service provider has a legally binding right to the amount."⁷

Rule 3: If "the service provider elects [payment in] a tax year later than the tax year in which he or she obtained a legally binding right to the payment, the arrangement constitutes a deferral," despite Rule 2.⁸

Thus, Notice 2005-1 apparently adds a taxpayer-unfavorable condition — that the arrangement "at all times . . . require payment" no later than 2½ months after the tax year end — whenever an amount is not actually paid in the year in which the service provider first acquires a legally binding right to the amount. That taxpayer-unfavorable condition is not reflected in the

¹2005-2 IRB 274, *Doc 2005-435*, 2005 TNT 4-7.

²Jobs Act section 885(d)(1) and (d)(2)(B). As discussed below in Part VIII, ambiguity exists as to whether, for an employer on a noncalendar fiscal tax year, section 409A applies to compensation deferred and vested after December 31, 2004, but before the end of the employer's 2005 fiscal year, e.g., compensation payable for services performed from January 1, 2005, through June 30, 2005, for a June 30 fiscal tax year employer.

³A technical correction bill introduced on July 21, 2005, as H.R. 3396 and S. 1447 (the Technical Corrections Bill) would clarify the effective date for (7) above, by requiring current inclusion, beginning in 2005, of all compensation — whether earned and vested before, on, or after December 31, 2004 — deferred under an arrangement under which assets to fund the deferred compensation are (a) set aside offshore or in an offshore trust or (b) restricted or required to be restricted in the future contingent on a change in the employer's financial condition, whether or not in each case the assets remain subject to the claims of the employer's general creditors.

⁴H.R. Rep. No. 108-755, 108th Cong., 2d Sess. 734-735 (hereinafter 2004 Conference Report); temp. reg. section 1.404(b)-1T Q&A 2(b)(1).

⁵Throughout this article, phrases like "actually paid" include "constructively received" by the service provider, which means, in general, that the service provider could have received the payment without substantial penalty but choose not to accept payment.

⁶Notice 2005-1, section IV.A, Q&A 4(a).

⁷Notice 2005-1, section IV.A, Q&A 4(c). The notice grants another exception for compensation paid after the last day of the service provider's tax year under the "timing arrangement under which the [employer] normally compensates service providers for services provided during a payroll period described in section 3401(b)." Notice 2005-1 section IV.A, Q&A 4(b). A "payroll period" means the employer's regular payroll period (e.g., weekly, semimonthly, etc.). See reg. section 31.3401(b)-1(a).

⁸Notice 2005-1, section IV.A, Q&A 4(c). We assume throughout that each service provider uses a calendar tax year.

legislative history (which merely requires that the payment actually be made no later than 2½ months after the tax year end). Thus, unless future guidance eliminates the required-to-be-paid condition, it seems that section 409A's penalties may not be avoided (when the compensation is not paid in the year the service provider first acquires a legally binding right) simply by paying the compensation within 2½ months after the end of the tax year in which the service provider acquires a legally binding right (when the deferral does not otherwise comply with section 409A's requirements — see Part III below).

Example 1

Newco (a calendar-year taxpayer) awards and pays annual bonuses each December 31, but it permits an executive to elect in writing to defer bonus payment to a date specified in the election. For executive A's year 1 bonus (expected to be awarded on December 31 of year 1), A files a written election deferring payment until December 31 of year 5. However, A does not make the year 1 written deferral election until September 15 of year 1 (rather than before the beginning of year 1 as generally required by section 409A — see Part III.A.1 below), that is, A's election violates section 409A's election-timing requirement.

Newco (discovering on December 15 of year 1 A's violation of section 409A's election-before-beginning-of-year-requirement) — although not "required" to pay A's year 1 bonus until December 31 of year 5 — nevertheless pays A's year 1 bonus on December 31 of year 1 (that is, before the end of Newco's tax year (year 1) in which A acquires a legally binding right to the bonus). The bonus does not constitute deferred compensation, and is not subject to the 20-point penalty tax (despite either (a) A's section 409A noncompliant deferral election or (b) Newco's acceleration of the payment), because under Rule 1 compensation is not deferred if actually paid during the year A first acquires a legally binding right to the compensation.

Example 2

Same as Example 1, except that A's written deferral election for A's year 1 bonus is made within the period necessary to satisfy section 409A's election-timing requirements (generally before the beginning of year 1 — see Part III.A.1 below). Nevertheless, Newco pays the bonus to A by December 31 of year 1.

Because the bonus is paid during Newco's tax year in which A first becomes legally entitled to the payment, the bonus does not constitute deferred compensation under Rule 1 (even though not "required" to be paid within 2½ months after the end of year 1), and therefore is not subject to the 20-point penalty tax (despite Newco's acceleration of the payment).

Example 3

Same as Example 1, except that Newco (not discovering until January 15 of year 2 A's violation of section 409A's election-timing requirement) —

although not "required" to pay A's year 1 bonus until December 31 of year 5 — nevertheless pays A's year 1 bonus during the first 2½ months of year 2 (that is, within 2½ months after the end of Newco's and A's tax year (year 1) in which A first acquires a legally binding right to the bonus).

Under the wording of Notice 2005-1, the bonus constitutes deferred compensation taxable to A in year 1 with a 20-point penalty tax, because the plan's terms require payment on December 31 of year 5, that is, the plan does not "require" payment within 2½ months after the end of year 1.

Under Rule 1, compensation constitutes deferred compensation if not actually paid during the year in which A first acquires a legally binding right to the compensation (here year 1) and under Rule 2 compensation paid during the next 2½ months is not protected from Rule 1 unless "at all times *the terms of the plan require payment by*, and an amount is actually [paid]" within 2½ months after the end of the vesting year (here year 1).

Example 4

Same as Example 2 (that is, the service provider's election is made within the period necessary to satisfy section 409A's election-timing requirement), except that Newco pays the bonus during the first 2½ months of year 2 rather than during year 1.

As in Example 3, the bonus constitutes deferred compensation because the bonus was not "required" to be paid within 2½ months after the end of year 1 (and is not actually paid in year 1). Moreover, the bonus is taxable to A in year 2 with a 20-point penalty tax plus an interest charge,⁹ because payment of the bonus in year 2 — more than three years before the deferred payment date elected by A — constitutes an impermissible acceleration of deferred compensation (see Part III.C below).

Example 5

Same as Example 1, except that A's September 15, year 1 (section 409A noncompliant) written deferral election defers payment only until February 28 of year 2 (that is, within 2½ months after the end of Newco's and A's tax year (year 1) in which A first acquires a legally binding right to the bonus) *and*, absent A's deferral election, the bonus would have been paid during year 1. The terms of A's deferral election require Newco to pay the bonus, and Newco actually pays the bonus, no later than March 15 of year 2.

Under the wording of Notice 2005-1, the bonus constitutes deferred compensation because A elected to receive payment in a tax year after the tax

⁹In addition to the 20-point penalty tax, an interest charge is imposed at the IRS underpayment rate on the amount of section 409A-tainted deferred compensation to the extent income is included under section 409A in a tax year after the compensation was deferred (or, if later, the year the deferred compensation vests) — see Part IV below.

year in which A first became legally entitled to the payment, and hence the arrangement constitutes a deferral under Rule 3, despite Rule 2. Consequently, the bonus is taxable to A in year 1 with a 20-point penalty tax, because A's deferral election was not timely.

Example 6

Same as Example 2 (that is, the service provider's election is made within the period necessary to satisfy section 409A's election-timing requirement), except that A's deferral election does not specify a precise payment date and instead provides merely that the bonus shall be payable at some time within the first 2½ months after the end of year 1 *and*, absent A's deferral election, the bonus would have been paid on December 31 of year 1.

The arrangement constitutes deferred compensation because, in this case, Rule 2 (no deferral of compensation if amount "required" to be, and is, paid within 2½ months after the end of the year in which the service provider first acquires a legally binding right to the payment) is overridden by Rule 3 (despite Rule 2, compensation is deferred if the service provider elects to receive payment after the end of the year in which legal entitlement to the payment first arises and the payment is not made in that year).

Moreover, because the terms of the deferral do not specify a precise payment date — but rather require payment only within a 2½ month window — the arrangement arguably flunks section 409A's distribution-trigger rule (requiring a date or fixed schedule for payment — see Part III.B below), so that arguably the bonus is taxable to A in year 1 with a 20-point penalty tax.

Example 7

Same as Example 1, except that A's year 1 bonus is subject to an SRF that expires on June 30 of year 3 and Newco (discovering on June 30 of year 3, when the SRF expires, A's violation of section 409A's election-timing requirement) — although not "required" to pay A's year 1 bonus until December 31 of year 5 — nevertheless pays A's year 1 bonus during year 3.

Same result as Example 3, that is, under the wording of Notice 2005-1, the bonus constitutes deferred compensation, taxable in this case in year 3 (when the SRF expires) with a 20-point penalty tax, even though paid during the vesting year (year 3), because the plan terms do not require payment during or within 2½ months after the end of the vesting year (here year 3).

Example 8

On January 1 of year 2, Newco awards an annual bonus to executive A for services rendered during year 1. A's right to receive the bonus does not become legally binding until the award date (that is, January 1 of year 2).

The bonus does not constitute deferred compensation as long as either (a) Newco actually pays the bonus by December 31 of year 2 (that is, the end of

Newco's tax year (year 2) in which A acquires a legally binding right to the bonus) or (b) the bonus is "required" to be paid and is actually paid by March 15 of year 3 (that is, 2½ months after the end of Newco's and A's tax year (year 2) in which A acquires a legally binding right to the bonus).

If, however, Newco neither pays the bonus by December 31 of year 2 nor is "required" to and does pay the bonus during the first 2½ months of year 3, the bonus constitutes deferred compensation taxable to A in year 2 with a 20-point penalty tax unless section 409A's deferral requirements are satisfied.

The statute uses the term "taxable year" without stating whether the reference is to the employer's tax year or the service provider's tax year, which normally differ when the employer uses a noncalendar tax year.¹⁰ However, Notice 2005-1 resolves the issue in a taxpayer-favorable manner for purposes of Rule 2 (that is, the 2½ month rule), by phrasing Rule 2 as the payment is "required" to be, and is actually, paid by 2½ months after the end of the later of the employer's or the service provider's first tax year in which there is no SRF.

Example 9

Newco (a fiscal-year taxpayer with a June 30 tax year end) awards annual bonuses each June. Under its written compensation policy, each annual bonus is required to be paid, and is actually paid, no later than March 15 of the calendar year immediately following the calendar year in which the bonus is awarded. During June of year 1, Newco awards executive A a bonus for services performed during Newco's tax year ending on June 30 of year 1. Newco pays A the bonus on or shortly before March 15 of year 2.

Under Notice 2005-1's 2½ month rule, A's bonus does not constitute deferred compensation since the bonus is "required" to be paid, and is actually paid, within 2½ months after the later of (1) the December 31, year 1 end of the service provider's tax year in which the compensation is earned and vested or (2) the June 30, year 1 end of the employer's tax year in which the compensation is earned and vested.

It is not clear whether future guidance will adopt a similar taxpayer-favorable approach to this issue for other purposes of section 409A (for example, the election timing rule, discussed in Part III.A.1 below) or will instead adopt a stricter rule for some or all purposes of section 409A. If a stricter rule is adopted in future regulations, we expect the employer's tax year will generally govern, because compensation is usually established for periods corresponding to the employer's accounting period.

Compensation subject to an SRF (that is, vesting) over a period spanning more than one tax year is not deferred

¹⁰2004 Conference Report at 732.

compensation if (as described in Notice 2005-1) “required” to be paid, and actually paid, by 2½ months after the later of (1) the end of the service provider’s tax year in which the service provider first acquires a vested legally binding right or (2) the end of the employer’s tax year in which the service provider first acquires a vested legally binding right. However, under Notice 2005-1, deferred compensation status cannot be avoided by adding (or extending) an SRF to the payment after the beginning of the service period to which the payment relates.¹¹

Notice 2005-1’s definition of SRF generally tracks the section 83 regulations’ definition (see *Ginsburg and Levin Treatise* para. 1502.1),¹² but adds the limitation that a service provider’s obligation to refrain from providing services to a competitor (that is, a noncompete covenant) is disregarded for section 409A purposes.¹³ The section 83 regulations, by contrast, allow such a noncompete condition to constitute an SRF when the facts and circumstances show that the undertaking creates a substantial risk the property will be forfeited.

III. Section 409A Deferral Requirements

Once it is determined that an arrangement constitutes deferred compensation, the arrangement can avoid current income inclusion and penalties under section 409A only if the arrangement:

- (1) satisfies specified strict timing requirements for a service provider’s deferral election and meets onerous restrictions on amending a service provider deferral election;
- (2) allows payment of the amount deferred only on occurrence of one or more of six permissible payment triggers; and
- (3) does not permit accelerated payment of the deferred amount except in very limited circumstances.

¹¹Notice 2005-1, section IV.A, Q&A 10(a) (“Any addition of [an SRF] after the beginning of the service period to which the compensation relates, or any extension of a period during which the compensation is subject to [an SRF], in either case whether elected by the service provider, service recipient, or other person (or by agreement of two or more such persons), is disregarded for purposes of determining whether such compensation is subject to [an SRF].”).

¹²Those regulations state that (1) Newco’s transfer of “property . . . [to a service provider is] conditioned . . . upon the [service provider’s] future performance [of substantial services, e.g., time vesting based on continued employment] . . . (or refraining from performance . . . of substantial services [e.g., a post-employment noncompete covenant]) . . ., or the occurrence of a condition related to a purpose of the transfer [e.g., a specified increase in Newco’s earnings], [2] . . . the possibility of forfeiture is substantial if such condition is not satisfied [, and (3) such a condition does not constitute an SRF] . . . to the extent [Newco] is required to pay the fair market value of a portion of such property to the [service provider when he or she] . . . return[s] . . . such property [upon failure of the condition].” Reg. section 1.83-3(c).

¹³Notice 2005-1, section IV.A, Q&A 10(a).

While the first requirement applies only when the service provider has a front-end choice (that is, an election) to defer, the last two requirements apply whether the service provider has a front-end choice or the employer merely awards deferred compensation to the service provider.

A. Deferral Election Timing Requirements

1. Initial election. When the service provider is given the right to defer non-performance-based compensation for services rendered during a tax year, the service provider generally must make the election to defer no later than the close of the preceding tax year.¹⁴

However, a service provider may elect to defer compensation within 30 days after first becoming eligible to participate in a deferral plan, but in that event the service provider can defer compensation only for services performed after the election is made.¹⁵

Regarding performance-based compensation, a service provider’s election to defer may be made after the beginning of, but no later than 6 months before the end of, the performance measurement period as long as (1) the period is at least 12 months long and (2) the amount of compensation is not readily ascertainable at the time of the election.¹⁶ October 2004 legislative history states that “performance-based compensation” is intended to have a meaning similar to its section 162(m) definition, that is, compensation that is based on a pre-established, objective formula, the outcome of which is substantially uncertain when established.¹⁷

However, pending issuance of regulations defining “performance-based compensation” for purposes of section 409A, Notice 2005-1 states that a bonus may be deferred under the performance-based timing rule even if payment of the bonus is based on subjective criteria, as long as the following requirements are satisfied:

- The amount is based on satisfaction of “organizational or individual performance criteria.”
- The performance goals are “not substantially certain to be met” at the time deferral is elected.
- Any subjective performance criteria must be based on the service provider’s individual performance, or on the performance of a group, business unit, or organization that includes the service provider.
- The determination of whether the service provider satisfies any subjective performance criteria may not be made by the service provider, his spouse, or any of his siblings, ancestors, or lineal descendants (or spouse of any such person).¹⁸

Notice 2005-1 cautions that a more restrictive definition of performance-based compensation is expected to be adopted by future regulations. However, until regulations are issued, virtually all annual and longer-term bonuses seem to qualify under the performance-based 6-month election rule when the “not substantially certain

¹⁴Section 409A(a)(4)(B)(i).

¹⁵Section 409A(a)(4)(B)(ii).

¹⁶Section 409A(a)(4)(B)(iii).

¹⁷2004 Conference Report at 732.

¹⁸Notice 2005-1, section IV.D, Q&A 22.

to be met” requirement is satisfied, because bonuses by definition are based on individual and/or business performance.

2. Subsequent election. A subsequent election to further defer payment of previously deferred compensation (whether or not performance-based) must satisfy each of the following requirements:

- the subsequent election may not be effective for at least 12 months after it is made;¹⁹
- the subsequent election must defer the first payment with respect to which the election is made at least an additional five years, unless the payment is triggered earlier by the service provider’s death, disability, or unforeseeable emergency;²⁰ and
- the subsequent election must be made at least 12 months before the first scheduled payment.²¹

Read literally, section 409A’s subsequent election requirements preclude a subsequent deferral election when the original deferral terms include a “change in control” or separation from service distribution trigger, because the at-least-12-months-before-first-scheduled-payment rule could apparently be violated if a change in control or separation from service occurs within 12 months after the subsequent election.

Alternatively (and somewhat more sensibly), the statute could be read as voiding the subsequent deferral election if (and only if) a change in control or separation from service occurs within 12 months after the subsequent election date (under the subsequent-election-may-not-be-effective-for-at-least-12-months rule). Under that reading, if a change of control or separation from service occurs more than 12 months after the subsequent election date, the five-additional-years-deferral rule would apparently require that any payment triggered by change in control or separation from service not be made until five years after the change in control or separation from service.

B. Permissible Distribution Triggers

The deferral arrangement may not permit payment to be made “earlier than”:²²

- (1) the service provider’s separation from service (but no earlier than 6 months following separation from service in the case of a key employee²³ of a public corporation);
- (2) the service provider’s disability;
- (3) the service provider’s death;
- (4) a date or fixed schedule established at the time of deferral;
- (5) to the extent permitted under regulations, a change in ownership or effective control, or a

change in ownership of a substantial portion of the assets of, a corporation (a “change in control event”);²⁴ and

(6) the occurrence of an unforeseeable emergency, defined narrowly as described below.

Payment may not be triggered by the occurrence of an event the timing of which is uncertain, for example, the date the service provider’s firstborn child begins college.

Read literally (“plan provides that compensation may not be distributed *earlier than*” six specified events),²⁵ the statute seems to permit a deferral arrangement that (1) specifies a “permissible” trigger, for example, a specified future payment date (the first trigger) and (2) either (a) establishes a second, “nonpermissible” trigger that also must be satisfied before payment occurs (a “dual-trigger” arrangement) or (b) gives the employer the right to make payments at its discretion after the first trigger (an “employer discretion” arrangement). Under such a literal reading, an arrangement might provide for payment of deferred compensation on the later of (1) June 15 of the year following the award or (2) the date the service provider’s firstborn child begins college.

However, the October 2004 legislative history states that “a nonqualified deferred compensation plan may not allow distributions other than *upon* the permissible distribution events.”²⁶ That statement suggests that a “dual-trigger” arrangement as described above does not satisfy section 409A’s distribution timing requirements because payment could be made “upon” the occurrence of a nonpermissible trigger under such an arrangement.

On the other hand, that legislative history seems to permit an arrangement under which payment is made on occurrence of a permissible trigger, but only if another nonpermissible trigger has occurred at or before the time the permissible trigger occurs (for example, payment on a service provider’s separation from service) and the employer underwent an IPO during the 12 months ending on the service-separation date; otherwise payment on the service provider’s 65th birthday.

The October 2004 legislative history quoted above also suggests that employer discretion to delay payment after the specified date is impermissible, and Notice 2005-1 generally confirms that — at least when the employer exercises that discretion — stating that “if an employer retains the discretion under the terms of the plan to delay or extend payments under the plan *and exercises such discretion*, the plan will not be considered to be operated in good faith compliance with section 409A with regard to *any plan participant*.”²⁷ However, the result is unclear if the employer has, but does not exercise, that discretion.

The statutory language also facially permits deferred compensation to be paid out in installments, beginning with the occurrence of a permissible trigger event (for example, a service provider’s separation from service),

¹⁹Section 409A(a)(4)(C)(i).

²⁰Section 409A(a)(4)(C)(ii). The Technical Corrections Bill would clarify that the additional five-year deferral “is not limited to the first payment for which deferral is made.”

²¹Section 409A(a)(4)(C)(iii).

²²Section 409A(a)(2)(A).

²³As defined in section 416(i), without regard to section 416(i)(5). Section 409A(a)(2)(B)(i).

²⁴This provision in new section 409A seems to have been copied substantially verbatim from section 280G, which applies only to compensation paid by a corporation.

²⁵Emphasis added.

²⁶2004 Conference Report at 730 (emphasis added).

²⁷Notice 2005-1, section IV.D, Q&A 19(b) (emphasis added).

according to a schedule established at the time of deferral (for example, five equal annual installments, beginning with the service provider's retirement date). The legislative history is, however, ambiguous, because the phrase "may not allow distributions other than upon the permissible distribution events"²⁸ can be read as suggesting the entire amount must be paid upon occurrence of the permissible triggering event.

On the other hand, the House committee report may be read as approving such an arrangement:

The time and form of distributions must be specified at the time of the initial deferral. A plan could specify the time and form of payments that are to be made as a result of a distribution event (e.g., a plan could specify that payments upon separation of service will be paid in a lump sum within 30 days of separation from service).²⁹

However, a more conservative reading of that legislative history is that payment on the occurrence of a permissible distribution trigger may be made within a reasonable (for example, 30-day) period following that occurrence (as opposed to impractically requiring payment immediately on the distribution trigger event's occurrence). Nevertheless, we find it hard to believe Congress or the IRS intend to impose section 409 penalties on normal, fixed-schedule payments triggered (for example) by separation from service, death, or disability.

An "unforeseeable emergency" is defined as a "severe financial hardship" resulting from illness, accident, casualty, or similar event.³⁰ The statute directs the IRS to issue regulations limiting the amount that may be distributed under the "unforeseeable emergency" trigger to an amount necessary to satisfy the emergency, plus taxes on the distribution, after taking into account insurance payments and the service provider's ability to liquidate his own assets without "severe financial hardship."³¹

Notice 2005-1 defines as follows the change in control events that constitute permissible deferred compensation distribution triggers:³²

- A change in target corporation's (T's) ownership occurs on the date that any person (or persons acting as a group) acquires ownership of stock that,

together with stock already owned by the person or group, represents more than 50 percent of T's total value or voting power.³³

- A change in T's effective control occurs on the date that either (1) any person (or persons acting as a group) acquires during a 12-month period stock that represents 35 percent or more of T's voting power³⁴ or (2) a majority of the members of T's board of directors is replaced during a 12-month period by persons not endorsed by a majority of the previous board, unless another corporation owns more than 50 percent of T's stock (by vote and value).³⁵
- A change in ownership of a substantial portion of T's assets occurs on the date that a person (or persons acting as a group) acquires, within a 12-month period, assets having a total gross fair market value (that is, without regard to liabilities) equal to 40 percent or more of T's assets.³⁶ For that purpose, the following transfers are disregarded: any transfer of T's assets (1) to a shareholder in exchange for or with respect to his T stock, (2) to an entity 50 percent or more of the total value or voting power of which is owned by T or by persons who own 50 percent or more of T's stock (by vote or value), or (3) to a person (or persons acting as a group) who owns 50 percent or more of T's stock (by vote or value).³⁷

In applying those rules:

- (1) A change in control event is deemed to occur for a service provider who has deferred compensation if the event relates to (a) the corporation for which the service provider is rendering services at the time of the change in control, (b) the corporation that is liable for the deferred compensation, or (c) any direct or indirect majority shareholder corporation of a corporation described in (a) or (b).³⁸ A "majority shareholder" of a corporation is a shareholder that directly owns more than 50 percent of the stock (by vote and value) of the corporation. A shareholder is an indirect majority shareholder of a corporation described in (a) or (b) if the shareholder is part of a chain of corporations in which each corporation is a majority shareholder of another corporation, ending in the corporation described in (a) or (b).

²⁸Emphasis added.

²⁹H.R. Rep. No. 108-548, 108th Cong., 2d Sess. 345 (emphasis added).

³⁰Section 409A(a)(2)(B)(ii)(I).

³¹Section 409A(a)(2)(B)(ii)(II).

³²Notice 2005-1, section IV.B, Q&A 11-14. As expected, those provisions generally track the corresponding section 280G regulations. See reg. section 1.280G-1, Q&A 27-29, discussed in *Ginsburg and Levin Treatise* para. 1506.2. The October 2004 legislative history's suggestion that a more restrictive definition of change in control be used for section 409A purposes (see 2004 Conference Report at 730) is reflected to only a minor degree. Also, as noted previously, the change-in-control-event provisions in section 409A apply only to corporations. The corresponding Notice 2005-1 provisions do not extend that distribution trigger to noncorporate employers.

³³Notice 2005-1, section IV.B, Q&A 12.

³⁴Notice 2005-1, section IV.B, Q&A 13(a). The corresponding section 280G provision differs from that rule in two respects: (1) the threshold percentage of voting power that must be acquired to trigger a section 280G change in T's effective control is lower (20 percent rather than 35 percent) and (2) an acquisition of the threshold percentage of T stock creates a rebuttable presumption that a section 280G change in T's effective control has occurred (rather than an irrebuttable presumption in the case of the section 409A definition).

³⁵Notice 2005-1, section IV.B, Q&A 13(a).

³⁶Notice 2005-1, section IV.B, Q&A 14(a). The threshold percentage of T's gross asset FMV value that constitutes a "substantial portion" of T's assets is lower (one-third rather than 40 percent) for section 280G purposes.

³⁷Notice 2005-1, section IV.B, Q&A 14(b).

³⁸Notice 2005-1, section IV.B, Q&A 11(b).

(2) Persons are not treated as part of a group merely because they purchase stock at the same time or as part of a single public offering, and, consequently, an IPO is not a permissible distribution trigger event. However, persons are treated as part of a group if they are owners of an entity that enters into a merger, stock acquisition, or similar transaction with T. A person who owns stock in both T and the purchasing corporation (P) is considered to be acting as a group with respect to the other P shareholders only to the extent of that person's ownership of P stock before the transaction, and not for that person's T ownership.³⁹

(3) Notice 2005-1 states that "[a] change in effective control also may occur in any transaction in which either of the two corporations involved in the transaction has a change in control event under [the change-in-T's-ownership rules or the change-in-ownership-of-a-substantial-portion-of-T's-assets rules]."⁴⁰ That rule differs from the "one change" rule that applies for section 280G purposes, that is, a section 280G change in effective control may not occur in any transaction in which either of the two corporations involved in the transaction has a section 280G change in ownership or control.⁴¹

(4) If a person or group already has ownership or effective control of T, the acquisition of additional stock or additional control by that person or group does not cause a change in ownership or control.⁴²

(5) Section 318(a)'s attribution rules apply in determining stock ownership.⁴³ In applying section 318(a)(4) option attribution, Notice 2005-1 treats stock underlying an option as constructively owned by the option holder only if (a) the option is vested and (b) the option is exercisable for stock that is substantially vested.

(6) Unlike the corresponding section 280G rules, members of the same affiliated group of corporations (as defined in section 1504(a)) are not treated as a single corporation.⁴⁴ However, as noted in (1) above, in some cases the acquisition of a parent corporation constitutes a change in control event for deferred compensation arrangements established by the parent's subsidiary corporations.

C. Acceleration Generally Not Permitted

The arrangement must not permit acceleration of any deferred payment, except under circumstances to be

identified in regulations.⁴⁵ The statute is unclear whether an arrangement (1) must explicitly prohibit acceleration or (2) simply not contain any explicit language permitting acceleration.

Examples identified in the legislative history, and confirmed by Notice 2005-1, of circumstances in which accelerated withdrawals from a deferred compensation account are permitted include: (1) a court-ordered withdrawal (for example, under a federal conflict of interest rule or a divorce decree) and (2) a withdrawal to pay the service provider's share of Social Security and Medicare taxes on the deferred compensation (which taxes are payable when the deferred compensation vests, even if the compensation is deferred for income tax purposes).⁴⁶

Notice 2005-1 states that waiving, or accelerating the expiration of, an SRF does not constitute an impermissible payment acceleration if "the requirements of section 409A are otherwise satisfied,"⁴⁷ that is, as long as actual payment is not accelerated. For example, when a service provider elects (in accordance with section 409A's election timing requirement) to defer until the end of year 10 payment of compensation that vests at the end of year 5, his employer's waiver at the end of year 3 of any further vesting does not constitute an impermissible payment acceleration so long as the compensation is not paid (or constructively paid) until the end of year 10. However, if the payment date is also accelerated, for example, to the end of year 8, the acceleration of the payment date causes the compensation to be subject to current income inclusion and penalties (20 additional points of tax).⁴⁸

IV. Consequences of Compliance Failure

If a deferral arrangement fails to comply with all three of the requirements summarized in Part III above, or at any time fails to be operated in accordance with all three such requirements, the consequences to each service provider to whom the failure relates are severe:

- all amounts that have been deferred under the arrangement and all similar arrangements are required to be included in income currently (or, if later, when vested);⁴⁹
- an additional 20 percentage points of tax is assessed on the total amount required to be included in the service provider's income (resulting in a top federal income tax rate of 55 percent);⁵⁰ and
- interest is assessed, at the IRS underpayment rate plus 1 percentage point, on the tax that would have been imposed on the deferred compensation had the compensation not been deferred, from the later of

³⁹Notice 2005-1, section IV.B, Q&A 12(b).

⁴⁰Notice 2005-1, section IV.B, Q&A 13(b).

⁴¹See reg. section 1.280G-1, Q&A 27(b), discussed in *Ginsburg and Levin Treatise* para. 1506.2.

⁴²Notice 2005-1, section IV.B, Q&A 12(a) and 13(c).

⁴³Notice 2005-1, section IV.B, Q&A 11(c).

⁴⁴Another portion of the notice — defining "service recipient" — uses a section 414(b) and (c) group concept (see Notice 2005-1, section IV.A, Q&A 5), but the change-in-control-event provisions of the notice do not import that concept; rather, those provisions use the term "corporation" rather than "service recipient."

⁴⁵Section 409A(a)(3).

⁴⁶2004 Conference Report at 731; Notice 2005-1, section IV.C, Q&A 15(b), (c), and (f).

⁴⁷Notice 2005-1, section IV.C, Q&A 15(a).

⁴⁸This taxpayer-adverse conclusion may be a bit unclear when the original election called for vesting at the end of year 5 and payment five years after vesting, so that employer waiver of further vesting at the end of year 3 automatically advances the payment date to the end of year 8 (that is, five years after vesting).

⁴⁹Section 409A(a)(1)(A)(i).

⁵⁰Section 409A(a)(1)(B)(i)(II).

the year in which the compensation (a) is deferred or (b) vests.⁵¹ That interest charge applies only when the arrangement (when created) was section 409A-compliant and a section 409A violation (for example, impermissible acceleration) occurs in a tax year after the tax year in which the compensation was deferred.

Notice 2005-1 describes three categories of deferred compensation arrangements and states that all of a service provider's deferred compensation falling within a single category are treated as deferred under a single arrangement for purposes of section 409A:⁵²

- *Account balance plans* (as defined in reg. section 31.3121(v)(2)-1(c)(1)(ii)(A)), that is, a plan under which the amount payable to the service provider is based on deferred compensation (and earnings thereon) credited to a notional account established for the service provider.
- *Non-account-balance plans* (as defined in reg. section 31.3121(v)(2)-1(c)(2)(i)), that is, a plan under which the amount payable to the service provider is not reflected in a separate notional account established for the service provider but rather is based on a formula that takes into account factors such as length of service and average pay during specified earning years.
- *Equity-based plans* (stock options, SARs, deferred stock units, and so forth) and all other plans except account balance plans and non-account-balance plans.

Under that grouping rule, the failure of any of a service provider's deferred compensation from an employer to comply with all three of the requirements taints all of the service provider's deferred compensation in the same category as the deferred compensation to which the failure relates. For example, if an employer maintains an account balance plan for an executive's salary deferrals and a separate account balance plan for the executive's annual bonus deferrals, a failure of either account balance plan to satisfy all three requirements causes all amounts deferred under both account balance plans to be subject to current income inclusion and penalties (20 percentage points of additional tax). However, issuance of a section 409A tainted NQO (for example, an NQO with an exercise price less than the underlying shares' FV on the grant date) to a service provider would not taint the service provider's "good" NQOs, because a "good" NQO is not treated as a deferred compensation arrangement.

When an arrangement fails to satisfy one or more of the three deferral requirements, investment returns (actual and notional) for all periods on the deferred compensation, and earnings in each subsequent period, are

⁵¹Section 409A(a)(1)(B)(i)(I) and (ii). The Technical Corrections Bill would "clarify" that neither the additional 20 percentage points of tax nor the interest charge is treated as a payment of regular tax for alternative minimum tax purposes.

⁵²Notice 2005-1, section IV.A, Q&A 9. The notice provides limited exceptions to this aggregation rule for purposes of its effective date and transition rule provisions. See Part VII below.

also subject to current income inclusion and penalties (for example, 20 percentage points of additional tax).⁵³

Deferred compensation that is subject to vesting and fails to satisfy one or more of the three deferral requirements (see Part III above) is subject to income inclusion and the penalties described above (20 percentage points of additional tax) when that compensation vests.⁵⁴ As discussed previously, Notice 2005-1 states that a payment subject to vesting is not deferred compensation, and therefore is not subject to section 409A, if "required" to be paid and actually paid within 2½ months after the end of the vesting year, for example, a payment right granted in year 1 contingent on the service provider remaining employed until the end of year 3 which is required to be, and is, paid during year 3 or within 2½ months after the end of year 3. See Part II above.

V. Deemed Funding Events

Under pre-October 2004 tax law (which continues to apply), deferred compensation is taxable when "funded" (but not before vesting) and is treated as "funded" when employer assets are set aside to pay that deferred compensation so that those assets are not subject to the claims of the employer's general creditors.⁵⁵ However, when the employer sets aside assets to pay deferred compensation but the assets set aside remain subject to the claims of the employer's general creditors, generally referred to as a "rabbi trust," such an arrangement is not considered "funded,"⁵⁶ subject to two changes made by the October 2004 legislation.

Under section 409A, either of the following two events (each a deemed funding event) is treated as a taxable transfer of property to the service provider:

(1) Assets are set aside in a trust (or certain other arrangements) for purposes of paying deferred compensation, and either the assets are, or the trust is, located outside the United States, unless substantially all the services to which the deferred compensation relates were performed in the foreign jurisdiction in which the assets reside.⁵⁷

(2) Assets are restricted or required to be restricted to the payment of deferred compensation on a change in the employer's financial condition, whether or not the assets are outside the United States.⁵⁸

In either case, property is treated as transferred even if the assets set aside remain subject to the claims of the employer's general creditors.

⁵³Section 409A(d)(5).

⁵⁴Section 409A(a)(1)(A)(i).

⁵⁵Rev. Rul. 60-31, 1960-1 C.B. 174 (situation (4)); *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952).

⁵⁶Rev. Rul. 60-31, *supra* note 55 (situations (1)-(3)); LTR 8113107 (Dec. 31, 1980); Rev. Proc. 92-64, 1992-2 C.B. 422, *modified in part by* Notice 2000-56, 2000-2 C.B. 393, *Doc 2000-25689*, 2000 TNT 195-3.

⁵⁷Section 409A(b)(1).

⁵⁸Section 409A(b)(2).

The tax consequences to the service provider of a deemed funding event are the same as for deferred compensation failing at least one of the three deferral requirements (described in Part III above), that is, current income inclusion (or, if later, inclusion in the year of vesting),⁵⁹ as described in Part IV above, tax at regular ordinary income rates plus an additional 20 percentage points producing a top federal rate of 55 percent, and, if the deemed funding event occurs after the end of the year in which the compensation vests, interest from the year of deferral (or, if later, the year of vesting) at the IRS underpayment rate plus 1 percent.⁶⁰ The amount subject to tax and penalties includes all prior periods' earnings (actual or notional) on amounts deferred, and earnings in each subsequent year also are taxed when earned, at a top rate of 55 percent.⁶¹

VI. Scope of Section 409A

A. Employees and Independent Contractors

Under Notice 2005-1, section 409A applies to compensation to (1) an employee of a corporate or noncorporate entity, (2) a corporate director, (3) a nonemployee service provider (but not if the nonemployee service provider is "actively engaged in the trade or business of providing substantial services . . . to two or more service recipients to which the service provider is not related and that are not related to one another,"⁶² and (4) under limited circumstances (described below), a partner in a partnership or a member of an LLC.

B. Partnerships and LLCs

Section 409A does not apply to allocations or distributions of income to a partner from a partnership (or an LLC treated as a partnership for tax purposes) for that person's interest in the partnership that is vested (or with respect to which a section 83(b) election has been made or deemed made by Rev. Proc. 2001-43, 2001-2 C.B. 191, *Doc 2001-20855*, 2001 *TNT 150-11*) — even when the partner acquired the partnership interest in connection with services rendered to or for the benefit of the partnership — because those allocations or distributions constitute a return on equity rather than compensation.

Also, even a partnership (or LLC) payment (or allocation) to a partner for services performed in a partner capacity, structured as salary or as a bonus not calculated

for partnership income, is apparently not covered by section 409A. Rather, that salary or bonus to a partner constitutes a "guaranteed payment" — defined in long-standing section 707(c) as a "payment . . . to a partner for services" "determined without regard to the income of the partnership" — that is, subject to special income and expense timing rules based on the partnership's (cash or accrual) method of accounting. Regulations under section 707(c) state that those "guaranteed payments are regarded as a partner's distributive share of ordinary income . . . [and a] . . . partner who receives guaranteed payments is not regarded as an employee of the partnership for purposes of . . . *deferred compensation plans*, etc."⁶³

However, section 409A may apply to deferred compensation payable to a partner for services not rendered in a partner capacity — see section 707(a)(1),⁶⁴ potentially including circumstances in which a purported allocation and distribution of partnership income is recharacterized as a section 707(a)(1) payment for services and therefore subject to section 409A.⁶⁵

A retired partner is treated (by section 736) as continuing to be a partner for tax purposes as long as the retired partner receives payments or allocations from the partnership, and hence those payments or allocations (whether characterized as a section 736(a)(1) distributive share of partnership income, a section 736(a)(2) guaranteed payment, or a section 736(b) liquidating distribution) should not be subject to section 409A for the reasons discussed above⁶⁶ (with one narrow exception, according to Notice 2005-1, for retirement payments exempt from self-employment tax — see section 1402(a)(10)).⁶⁷

Under Notice 2005-1, the issuance of a partnership (or LLC) interest, or the issuance of an option to acquire such an interest, in connection with the performance of services is viewed for section 409A purposes "under the same principles that govern the issuance of stock," subject to the Rev. Proc. 93-27, 1993-2 C.B. 343, *Doc 93-6562*, 93 *TNT 123-7* overlay (described in *Ginsburg and Levin Treatise* para. 1502.6) under which the value of a partnership (or LLC) interest is measured for section 83 purposes by its liquidation value (LV), that is, the amount the service provider would receive if the partnership were to sell its assets at FMV (determined at the time the service provider receives the partnership interest) and distribute the proceeds in complete liquidation of the partnership, rather than by its FMV.⁶⁸

⁵⁹Section 409A(b)(3).

⁶⁰Section 409A(b)(4).

⁶¹The Technical Corrections Bill would clarify the effective date for these deemed funding event rules, by requiring current inclusion, beginning in 2005, of all compensation — whether earned and vested before, on, or after December 31, 2004 — deferred under an arrangement under which assets to fund the deferred compensation are (a) set aside offshore or in an offshore trust or (b) set aside or required to be set aside in the future contingent on a change in the employer's financial condition, whether or not in each case the assets remain subject to the claims of the employer's general creditors.

⁶²Notice 2005-1, section IV.A, Q&A 8. Thus, section 409A does not apply to compensation received by a law firm, accounting firm, consulting firm, or individual nonemployee consultant providing services to multiple clients.

⁶³Reg. section 1.707-1(c) (emphasis added).

⁶⁴Notice 2005-1, section IV.A, Q&A 7.

⁶⁵Notice 2005-1, section III.A and section IV.A, Q&A 7.

⁶⁶Notice 2005-1, section IV.A, Q&A 7. However, the IRS in Notice 2005-1 requests comments on the extent to which future regulations should treat section 736 payments as subject to section 409A. Notice 2005-1, section III.A(3).

⁶⁷That is, payments to a partner rendering no services with respect to the partnership's trade or business, who has no remaining partnership capital interest, and who is owed no obligation by the remaining partners other than the obligation to cause the partnership to make the retirement payments.

⁶⁸"Issuance of a [partnership] profits interest . . . that is properly treated [under, e.g., Rev. Proc. 93-27] as not resulting in inclusion of income by a service provider . . . , also [does] not

(Footnote continued on next page.)

Thus, when a partnership interest is issued to a service provider, the service provider recognizes ordinary income (OI) equal to (1) the excess of the partnership interest's LV over the price paid by the service provider (when there is no vesting requirement or the service provider makes an actual or deemed section 83(b) election), which would be zero in the case of a pure profits interest, or (2) when there is a vesting requirement and the service provider neither makes nor is deemed to make a section 83(b) election, the excess of the partnership interest's LV at vesting over the price paid by the service provider.

However, even when those rules cause the service provider to recognize OI from receipt of the partnership interest, that OI does not constitute section 409A deferred compensation because the service provider's OI (1) is taxed immediately when the partnership interest is issued (when there is either no future vesting requirement or vesting with a section 83(b) election or deemed election) or (2) is taxed at vesting (when there is future vesting with no section 83(b) election or deemed election), that is, none of the OI is deferred beyond the year of vesting.⁶⁹

When, however, the service provider receives an option to acquire a partnership interest (analogous to a corporate NQO), section 409A does apply when the option is in the money at issuance. Notice 2005-1 is not wholly clear on whether a partnership-interest option is treated as in the money by comparing the option price to the partnership interest's LV or to its FV:

(a) Notice 2005-1 says "issuance of a partnership interest (including a profits interest) or an option to purchase a partnership interest" is governed by "the same principles that govern issuance of stock."⁷⁰ If that were the end of the statement, FV

result in the deferral of compensation [for section 409A purposes]." Notice 2005-1, section IV.A, Q&A 7.

As discussed in *Ginsburg and Levin Treatise* para. 1502.7, it is possible (but illogical) to read Rev. Proc. 93-27's ambiguous wording and conclude that the IRS intends the taxpayer-favorable LV rule to be available only when the service provider receives a pure profits interest, that is, the LV of the service provider's partnership interest at issuance is zero. For purposes of the discussion in Part VI, we assume the IRS does not adopt that illogical reading or, if it does, that reading does not prevail in court.

⁶⁹When the service provider receives an unvested partnership interest with no actual or deemed section 83(b) election and (while the partnership interest is still subject to an SRF) receives partnership distributions treated as compensation for tax purposes under reg. section 1.83-1(a)(1), it is not wholly clear whether that compensation constitutes "deferred" compensation for section 409A purposes. This issue turns on whether (1) the service provider is viewed as receiving a legally binding right to the distribution in a year before the distribution and (2) if so, whether that right is viewed as subject to an SRF (because the service provider would not have received the distribution if the unvested partnership interest had been forfeited before the distribution).

⁷⁰Notice 2005-1, section IV.A, Q&A 7.

would be the measuring rod because an option on stock is in the money if the option price is below FV (not LV).

(b) However, Notice 2005-1 immediately goes on to state that "issuance of a profits interest⁷¹ . . . properly treated under applicable guidance [that is, Rev. Proc. 93-27] as not resulting in the inclusion of income . . . also [does] not result . . . in the deferral of compensation."

If the Notice 2005-1 language quoted in (b) had said "issuance of a partnership interest or an option thereon," it would have been clear that an option on a partnership interest is in the money and hence constitutes deferred compensation only if the option price is below LV. However, we believe the omission of the option-thereon language is an oversight, because it would make little sense to measure the amount of OI recognized by a service provider receiving a partnership interest by reference to the partnership interest's LV, as Notice 2005-1 clearly does, but then determine whether an option on a partnership interest constitutes deferred compensation by reference to the partnership interest's FV.

C. Contingent Compensation

Application of section 409A to compensation contingent on an event occurring after the year in which the services are performed (for example, an insurance agent's annual commission contingent on whether the policyholder pays the premium each year) is subject to two alternative potential interpretations under Notice 2005-1:

First, that contingent compensation could be viewed as compensation for which the service provider *does have* a "legally binding right" from the outset, *but* which is subject to an SRF/performance vesting (that is, a "condition related to the purpose of the [compensation])."⁷² Under that interpretation (which appears to be the one intended by Notice 2005-1),⁷³ the contingent compensation must, by its terms, be "required" to be paid, and must actually be paid, during, or within 2½ months after, the year in which the contingency is resolved (that is, the SRF expires) to avoid characterization as deferred compensation (that is, section 409A could not be avoided by

⁷¹*Id.* As discussed in *Ginsburg and Levin Treatise* para. 1502.6(7), May 2005 proposed regulations make clear that, when effective, the Rev. Proc. 93-27 rules now applicable to a profits interest will be applicable to all partnership interests (issued by a partnership electing the LV method) and imply that even now the Rev. Proc. 93-27 and Notice 2005-1 (issued January 2005) profits-interest rules apply to any portion of a partnership interest that constitutes a profits interest.

⁷²Notice 2005-1, section IV.A, Q&A 4(a) and (c).

⁷³"A service provider does not have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated by the service recipient or other person after the services creating the right to the compensation have been performed. . . . For this purpose, compensation is not considered subject to unilateral reduction or elimination merely because it may be reduced or eliminated by operation of the objective terms of the plan, such as the application of an objective provision creating a substantial risk of forfeiture." Notice 2005-1, section IV.A, Q&A 4(a).

actually paying the compensation in the year the contingency is resolved or within 2½ months thereafter if the payment is not “required” to be made within that time frame).

However, even under that interpretation, there would be no section 409A penalty if all three of the requirements described in Part III above are met (for example, paid according to a fixed schedule).

Second, the contingent compensation could be viewed as compensation for which the service provider does *not* have a “legally binding right” until the contingency is resolved and the amount of the payment subsequently determined. Under that interpretation, the contingent compensation is not deferred compensation as long as it is (1) paid by the end of the year in which the contingency is resolved or (2) “required” to be paid and actually paid within 2½ months thereafter.

For example, an insurance agent generally receives a commission for each year a policy originally sold by the agent remains in effect. Under the first interpretation above, the commission (even if paid in the year the policy premium is received), constitutes deferred compensation *unless* (a) the commission is by its terms “required” to be paid, and is actually paid, in the year the premium is received, or within 2½ months thereafter, or (b) the deferred compensation arrangement meets all three of the requirements discussed in Part III above.

However, under the second interpretation above, the compensation is not earned until the service provider’s legal entitlement to the payment becomes fixed and the amount of the payment reasonably determinable (for example, when the premium on the policy is paid each year) and hence does not constitute deferred compensation if actually paid by the end of, or “required” to be paid and actually paid within 2½ months after the end of, the year in which the commission becomes fixed and determinable.

D. Severance

Severance arrangements⁷⁴ are not excluded from section 409A’s definition of deferred compensation. The legislative history is silent regarding how section 409A applies to severance arrangements, and Notice 2005-1 requests comments on “[t]he application of section 409A to severance plans, including whether to exclude any specific types of severance plans or arrangements.”⁷⁵ In the absence of guidance on that question, we offer the following thoughts on how section 409A might apply to severance arrangements, based on the general rules contained in the statute and Notice 2005-1:

- **Severance negotiated in connection with separation, that is, no prior contractual right to severance.** Severance paid to a service provider during the year in which the severance arrangement is agreed on and service terminates (the separation year), or “required” to be paid, and actually paid, within 2½

months thereafter, does not constitute deferred compensation, because the service provider has no legal right to the payment until the separation year.

Severance not paid in the separation year, and not “required” to be paid and actually paid within 2½ months thereafter, seems to be subject to section 409A. To avoid section 409A’s penalties, any such payment must be made according to a fixed schedule or on the occurrence of other permissible distribution triggers (for example, death).

- **Prior contractual right to severance, subject to SRF.** A severance arrangement included in a service provider’s multiyear contract that is subject to an SRF (for example, the service provider is entitled to severance pay if fired without cause, but not on resignation without good reason) is not subject to section 409A as long as the severance is paid in the separation year, or is “required” to be paid, and is actually paid, within 2½ months thereafter, because the separation year is the year the severance payment right “vests.”

However, severance payments not “required” to be paid within 2½ months after the end of the separation year are apparently subject to section 409A, and it is not wholly clear that those payments can be structured to satisfy section 409A’s distribution trigger limitations.

For example, a typical severance provision requires the employer to continue paying the service provider’s regular salary, on the dates those payments would be made if the service provider had continued to be employed, for example for 24 months following the separation date if the service provider is fired without cause. When the service provider is fired without cause on June 30 of year 1, severance required to be paid after March 15 of year 2 is apparently subject to section 409A. As discussed in Part III.B above, the payments would satisfy the permissible distribution trigger rules under an expansive reading that allows payments to be made according to a preestablished schedule following the occurrence of a permissible distribution trigger (that is, separation from service, in this case), but would not satisfy section 409A’s permissible distribution trigger rules under a narrow reading (that is, based on the legislative history’s statement that payments must be made “upon the permissible distribution events” — emphasis added).⁷⁶

We find it hard to believe Congress or the IRS intend to impose section 409A penalties on normal, fixed-schedule severance arrangements, and hence we believe the expansive reading should prevail, but IRS guidance on this point is obviously needed.

⁷⁴A “severance arrangement” refers to payments (or benefits provided) to a service provider in connection with separation from service other than regular salary, prorated bonus, and benefits for services rendered through the separation date.

⁷⁵Notice 2005-1, section III.A(1).

⁷⁶The payment schedule would not qualify as a “fixed payment date” distribution trigger because the service separation date, and hence the specific dates on which the payments would be made, is unknown when the arrangement is entered into.

- **Prior contractual right to severance, not subject to SRF.** A right to severance pay not subject to an SRF (that is, the service provider is entitled to severance on termination of employment under all circumstances, perhaps other than termination for cause) in a multiyear contract is apparently subject to section 409A, because the payment is generally not made in the year in which the service provider first has a legally binding right (the contract year) and is not “required” to be made within 2½ months thereafter. If structured as a lump sum payment on separation from service, or within a short period thereafter (for example, 30 days — see Part III.B above), the payment satisfies section 409A’s permissible distribution trigger rules, but if structured as a series of payments following separation from service, the same issue regarding satisfaction of the permissible distribution trigger rules is presented as discussed immediately above in the case of severance subject to an SRF.

VII. Application to Specific Arrangements

A. Cash Payments

If an employer waits before awarding a service provider’s annual bonus for year 1 until completion of the year 1 audit (often more than 2½ months after the end of year 1), section 409A should not apply if the employer promptly thereafter pays the bonus, because the service provider has no legal right to the year 1 bonus until awarded by the employer in year 2, the same year as the bonus is paid.⁷⁷

If, however, the employer instead awards the year 1 bonus at the end of year 1 (for example, December 15 of year 1) but reserves the right to adjust and then promptly pay the bonus when year 1’s audit is completed in year 2 (that is, very likely more than 2½ months after the end of year 1), section 409A penalties would apply to the bonus (according to Notice 2005-1) if the employer’s “discretion to reduce or eliminate the compensation . . . is unlikely to occur or . . . unlikely to be exercised.”⁷⁸

That unfortunate consequence can be avoided if the bonus award at the end of year 1 either (a) specifies a fixed bonus payment date (for example, April 15 of year 2) when the employer believes the audit is substantially certain to be complete and does not accelerate payment if the audit is completed earlier (so that the bonus constitutes deferred compensation but satisfies section 409A’s specified date/fixed schedule permissible-payment trigger and no-acceleration rules — see Part III.B and C above) or (b) does not vest the bonus until sometime in year 2 (for example, the service provider would forfeit the bonus if he or she resigns before (for example) March 31 of year 2 or perhaps before audit completion) and also “requires” payment during year 2 or within 2½ months thereafter, so that the bonus is not deferred compensation.

⁷⁷Notice 2005-1, section IV.A, Q&A 4(a).

⁷⁸*Id.*

It appears that section 409A taint for a bonus awarded and vested at the end of year 1 but payable at audit completion cannot be avoided by simply paying the bonus within 2½ months after the end of year 1, because (as noted above) Notice 2005-1 takes the position that payment within 2½ months after the end of the year when the service provider first had a legally binding right does not avoid section 409A’s penalties unless the award’s terms “require” payment to be made by that time.

When a service provider elects to defer compensation to be earned over a period spanning more than one tax year, section 409A generally requires the deferral election to be made before the beginning of the first tax year of the service period (or for performance-based compensation, at least six months before the end of the performance period — see Part III.A above). For example, if in year 1 a service provider is awarded a bonus to be earned over three years and the service provider may elect to defer all or any portion of the bonus, the service provider generally must make the deferral election before January 1 of year 1 (or in some circumstances for a performance-based bonus, at least six months before the end of the performance period). See Part III.A above.

Alternatively, if the bonus does not qualify as performance-based and a newly promoted employee first becomes eligible to participate on a prorated basis in the bonus on July 1 of year 1, the employee can make a deferral election, for the portion of the bonus relating to services performed after that election, no later than July 31 of year 1.⁷⁹

B. Equity-Based Compensation

1. NQO. An NQO on corporate stock that is in the money when granted (that is, the FMV of the underlying shares at grant exceeds the NQO exercise price) constitutes section 409A deferred compensation.⁸⁰ An NQO that is in the money at grant apparently is taxable in the year of vesting, based on the underlying stock’s FMV at year end, at a top rate of 55 percent (unless by its terms the NQO grant satisfies section 409A’s three requirements — see Part III above). Also, any increase in the underlying stock’s FMV in each subsequent tax year is apparently also taxable at that time, at a top rate of 55 percent. It is not clear whether the service provider is entitled to a deduction for a tax year in which such an NQO declines in value, to the extent of the income included by the service provider for the NQO for prior tax years.

See also two special transitional rules for an NQO discussed in Part VIII(5) below.

The exact method for calculating the amount of section 409A-tainted income arising from an NQO that is in the money at grant is not, however, clear beyond doubt.

⁷⁹Section 409A(a)(4)(B)(ii). In that case, it is often difficult to determine the portion of the compensation relating to services performed after the deferral election. We hope regulations will authorize the use of simplifying conventions, e.g., daily apportionment, to alleviate measurement difficulties.

⁸⁰2004 Conference Report at 735; Notice 2005-1, section IV.A, Q&A 4(d)(i) and (ii). For treatment of an option on a partnership interest, see Part VI.B above.

There are two alternative approaches: *first*, the amount by which the NQO is in the money — that is, the amount by which the underlying stock's FMV exceeds the option price — at the end of the year of grant and then, at the end of each succeeding year, the amount by which that spread has increased; *second*, the FMV of the option (including the value of the option privilege) at the end of the year of grant and then, at the end of each succeeding year, the amount by which the option's FV (including the value of the remaining option privilege) has increased. While that issue — underlying stock FV versus option FV — is not explicitly addressed by the statute, the legislative history, or Notice 2005-1, the language of the latter two (as well as logic) points toward the underlying stock's FMV:

- The conference report, in discussing section 409A as a whole, states that “all amounts deferred under a non-qualified deferred compensation plan for all tax years are currently includible in gross income,”⁸¹ and “amounts deferred” seems more consistent with the spread between underlying stock FV and option price.
- The conference report states that the determination whether an NQO constitutes deferred compensation subject to section 409A at all turns on whether “the exercise price [of the NQO] . . . is . . . less than the fair market value of the underlying stock on the date of grant.”⁸²
- Notice 2005-1, in discussing an NQO that is in the money at grant and an SAR, states that Treasury and the IRS “request comments on appropriate techniques for valuation of stock subject to options where . . . such stock is not [traded] . . . , to ensure that such valuation reflects the actual fair market value of the stock.”⁸³

Accordingly, we believe that the proper measurement of section 409A income for an option in the money at grant turns on the stock FMV (rather than the option FMV).

An NQO that is at the money or out of the money at grant (that is, the exercise price of the NQO is at least equal to the FMV of the underlying shares at grant) is not subject to section 409A as long as it contains no deferral features other than the discretion to exercise at any time following vesting.⁸⁴ Notice 2005-1 states that “any reasonable valuation method [including the estate tax valuation method described in reg. section 20.2031-2] may be used” to determine the stock FMV at the grant date.⁸⁵

However, even with regard to such a “good” NQO, several issues remain:

- A material postgrant modification of a “good” NQO, at a time when the NQO is in the money, may constitute the grant of a new “bad” NQO treated as section 409A deferred compensation, triggering tax

at a top federal rate of 55 percent on the NQO's FMV spread in the year of the modification (or vesting, if later) and taxation in subsequent years on a mark-to-market basis.

- When P acquires T, P's grant of a P NQO in place of T's old “good” NQO (originally granted at the money but in the money when P acquires T) might be viewed as the grant of a new “bad” NQO treated as deferred compensation, triggering tax at a top federal rate of 55 percent on the NQO's FV spread in the year of the substitution (and taxation in subsequent years on a mark-to-market basis).

However, Notice 2005-1 substantially ameliorates this risk by providing that the P NQO is not treated as the grant of a new option (but rather is treated as a continuation of the original T NQO) for section 409A purposes if (1) the terms of the P NQO contain all the terms of the T NQO other than terms rendered inoperative by the transaction, (2) the terms of the P NQO (for example, the expiration date)⁸⁶ are not more favorable to the executive than the terms of the T NQO, (3) the ratio of the P NQO exercise price to the FMV of the underlying P shares (when the P option is issued) does not exceed the ratio of the T NQO exercise price to the FMV of the underlying T shares immediately before issuance of the P option, and (4) the FMV of the underlying P shares (when the P option is issued) does not exceed the FMV of the underlying T shares immediately before issuance of the P option.⁸⁷

- When Newco declares and pays an extraordinary dividend, it is not uncommon for Newco to reduce the exercise price of each outstanding Newco option by the amount of the dividend that would have been distributed on the underlying shares had the option been exercised, so that an optionholder is not forced to exercise the option to avoid losing the economic benefit of the extraordinary dividend. Although not free from doubt, it appears that such an exercise price reduction does not cause an otherwise “good” NQO (or ISO) to become section 409A-tainted, because an extraordinary dividend is included within the definition of “corporate transaction” contained in the regulations issued under section 424.⁸⁸
- In recent years many service providers (with their employers' consent) used the strategy of canceling an NQO shortly before it would otherwise have been exercised and substituting a deferred payment

⁸⁶However, although not free from doubt, accelerating the NQO's vesting in connection with the P-NQO-for-T-NQO substitution should not be treated as providing more favorable terms. Cf. section 424(h)(3)(C) (accelerating the time an ISO may be exercised is not treated as giving the holder “additional benefits under the option” resulting in a deemed cancellation and regrant of the option under section 424(h)(1)).

⁸⁷Notice 2005-1, section IV.A, Q&A 4(d)(ii). In other words, the substitution must satisfy the requirements of reg. section 1.424-1 (applied by treating the P and T NQOs as if they were ISOs). See reg. section 1.424-1(b)(5).

⁸⁸Reg. section 1.424-1(a)(3)(ii).

⁸¹2004 Conference Report at 729 (emphasis added).

⁸²2004 Conference Report at 735 (emphasis added).

⁸³Notice 2005-1, section I.B (emphasis added).

⁸⁴Notice 2005-1, section IV.A, Q&A 4(d)(ii); 2004 Conference Report at 735.

⁸⁵Notice 2005-1, section IV.A, Q&A 4(d)(ii).

right (generally in an amount equal to the spread in the cancelled NQO). However, after section 409A's enactment, canceling a "good" in-the-money NQO and substituting a deferred payment right constitutes creation of a deferred compensation arrangement that generally violates section 409A's requirement that any deferral election must precede the beginning of the tax year in which the compensation is earned (see Part III.A.1 above), so that the deferred compensation is subject to current income inclusion, at a top federal tax rate of 55 percent.

There is, however, an argument that substituting a deferred compensation arrangement for a "good" NQO can be structured to comply with section 409A's special performance-based compensation election-timing rule (deferral election at least six months before the end of a performance period lasting at least 12 months — see Part III.A.1 above) when (a) the deferred payment right is subjected to a performance-based contingency, (b) the performance-measurement period is at least 12 months, (c) the substitution occurs when at least 6 months of the performance-measurement period remain, (d) the amount of compensation is not readily ascertainable at the time of substitution, and (e) the payment terms meet section 409A's limitations on payment triggers (for example, payment only on death, separation from service, or a specified date — see Part III.B above).

Although that performance-based contingency approach seems to satisfy section 409A's statutory language, Notice 2005-1 states that "[a]ny addition of [an SRF] after the beginning of the service period to which the compensation relates, or any extension of a period during which the compensation is subject to [an SRF], . . . is disregarded for purposes of determining whether such compensation is subject to [an SRF]."⁸⁹ Although that SRF-disregard rule was included in Notice 2005-1 for reasons unrelated to the special six-month performance-compensation election rule, we would not be surprised if the IRS sought to apply Notice 2005-1's vesting-disregard rule to defeat the performance-based-contingency approach outlined above. Accordingly, there is doubt that the performance-based-contingency approach avoids section 409A's draconian penalties when a deferred compensation account is substituted for a "good" NQO.

- If the otherwise "good" NQO permits net exercise (that is, the service provider may pay the NQO exercise price by surrendering some of the NQO shares with an aggregate FV equal to the aggregate NQO exercise price) and also entitles the holder to receive cash in lieu of shares on a net exercise, Notice 2005-1 (treating tandem rights as a single arrangement for section 409A purposes) apparently treats the option-plus-cash-in-lieu-of-shares right as a single section 409A-tainted arrangement and

therefore taxable annually on a mark-to-market basis, at a top federal tax rate of 55 percent.⁹⁰

Moreover, an NQO with a net exercise feature but no cash-in-lieu-of-shares right may by itself cause such an NQO to be section 409A tainted (on the basis that such an arrangement is the functional equivalent of a deferred payment in the form of free stock). However, if the underlying NQO shares are publicly traded and the NQO terms satisfy Notice 2005-1's exception for SARs on publicly traded stock described below in Part VII.B.3, the net exercise feature should not cause the NQO to be section 409A tainted because the net exercise feature causes the NQO to be functionally equivalent to an SAR that satisfies the exception.

- An option typically contains a provision (applicable in the event of a sale of Newco) giving Newco the right to cancel the option for cash (equal to the option's spread value) or requiring the optionholder to accept the same consideration received by Newco stockholders in exchange for the option. There is risk that such a provision could be viewed as a "tandem arrangement" under Notice 2005-1's language,⁹¹ thereby causing the option to be treated as section 409A tainted, although we hope future regulations will clarify that such commercially standard provisions do not result in section 409A taint.
- 2. ISO.** An ISO "meeting the requirements of section 422" is not subject to section 409A.⁹²

When an option qualifies as an ISO when granted and exercised, but there is a subsequent "disqualifying disposition" of the shares received on exercise (that is, a sale of the shares within one year after exercise or within two years after ISO grant), the option does not satisfy all of section 422's requirements (because the disqualifying disposition violates section 422(a)(1)'s one-year-after-exercise and two-years-after-grant holding period requirements) and hence is apparently not protected by this favorable rule.⁹³ However, such a disqualified ISO should not constitute deferred compensation because of the exception for NQOs not in the money at grant, because an ISO cannot be in the money at grant.

3. SAR. A traditional SAR is exercisable (after vesting) on a date selected by the service provider and accordingly does not comply with section 409A's limitations on payment triggers — see Part III.B above. That SAR is therefore subject to the same harsh section 409A tax penalties as an in-the-money NQO (that is, taxable in the

⁸⁹Notice 2005-1, section IV.A, Q&A 10(a).

⁹⁰Notice 2005-1, section IV.A, Q&A 4(d)(ii). ("To the extent an arrangement grants the recipient a right other than to purchase stock at a defined price and such additional rights allow for the deferral of compensation (for example, tandem arrangements involving options and stock appreciation rights), the entire arrangement provides for the deferral of compensation.")

⁹¹Notice 2005-1, section IV.A, Q&A 4(d)(ii).

⁹²2004 Conference Report at 735; Notice 2005-1, section IV.A, Q&A 4(d)(iii).

⁹³Notice 2005-1 does not clarify this point, stating that "[t]he grant of an incentive stock option as described in section 422 . . . does not constitute a deferral of compensation." Notice 2005-1, section IV.A, Q&A 5(d)(iii).

year of vesting based on the underlying stock's FV at the end of that year, at a top federal tax rate of 55 percent, and in each subsequent year on a mark-to-market basis). It is not clear whether the service provider is entitled to a deduction for a tax year in which the SAR declines in value, to the extent of the income included by the service provider for the SAR for prior tax years.

Notice 2005-1 exempts from section 409A an SAR on publicly traded stock when: (1) the SAR's base price is not less than the underlying stock's FMV on the SAR grant date, (2) the underlying stock is traded on an "established securities market," (3) the holder may receive only shares of such traded stock on exercise, (4) there is no arrangement under which the employer will purchase the stock issued under the SAR, and (5) the SAR "does not include any feature for the deferral of compensation other than the deferral of recognition of income."⁹⁴

Notice 2005-1 also exempts from section 409A an SAR granted under a "program" in effect on or before October 3, 2004 (apparently without regard to when the SAR is granted), if the SAR meets requirements (1) and (5) above, in which case section 409A does not apply to that SAR even if the SAR relates to nontraded stock and is payable in cash.

An SAR that does not satisfy the requirements of an SAR safe harbor discussed above could be section 409A compliant if the SAR payment date(s) are permitted by the payment trigger limitations (for example, date or dates specified at time of grant, death, or separation from service — see Part III.B above), even if the service provider has the right to elect to freeze the SAR's value before the specified payment dates. However, such an arrangement may not be as attractive to a service provider as is an SAR that pays out as soon as exercised by the service provider.

See also two special transition rules for an SAR discussed in Part VIII(4) below.

4. Restricted stock unit (RSU). An RSU is the right to receive a specified number of shares of employer stock in the future or, in some cases, to receive cash equal to the value of a specified number of employer shares of stock at the time of payment. Typically, the right to receive the shares is subject to vesting, and the shares are issued when the vesting condition lapses unless the RSU holder elects to defer receipt of the shares. When the service provider makes no such deferral election, the RSU should not be treated as deferred compensation because the holder is subject to tax when the compensation is earned, that is, when the RSU vests and the underlying shares (or cash equivalent) are issued.

If the RSU holder elects to defer receipt of the underlying shares (or cash equivalent) beyond the end of the year in which vesting occurs (or beyond 2½ months thereafter when payment during such a 2½ month period would otherwise be required), the RSU constitutes section 409A deferred compensation.⁹⁵ To comply with

section 409A, (1) the holder generally must make the deferral election before the beginning of the tax year in which the RSU is granted (see Part III.A.1 above) and (2) the election must specify the date or dates the shares (or cash equivalent) are to be issued for the RSU, or the deferral must otherwise comply with section 409A's payment-trigger limitations — see Part III.B above.⁹⁶ However, it should be permissible for the terms of the RSU to allow the holder to elect to freeze the RSU's value at any time before the specified payment date.

As a practical matter, the section 409A election-timing requirement forces an employer planning to make RSU grants that are eligible for deferral elections to inform participants before the beginning of the tax year in which the RSU is granted, so that participants have the opportunity to make deferral elections before the beginning of the tax year in which the RSU is granted.

An employee who first becomes eligible to participate in an RSU plan during a tax year is theoretically permitted to make a deferral election within 30 days of first becoming eligible, but an election made after the grant (even though within the 30-day window) may not satisfy the requirement that the deferral be made only with respect to services to be performed subsequent to the election, because the potential value in any RSU grant will begin accruing as of the grant date.

5. Restricted stock. Restricted stock (that is, stock issued to a service provider that is nontransferable and subject to vesting) is not deferred compensation.⁹⁷ Any compensation income resulting from receipt of restricted stock is subject to tax (a) at vesting if the service provider does not make a section 83(b) election when the restricted stock is issued or (b) when the restricted stock is issued if the holder does make a section 83(b) election. Because that compensation is taxed not later than vesting (and that compensation should be viewed as "required to be paid" at this time), the compensation does not constitute deferred compensation and any subsequent appreciation in the stock represents an equity return rather than compensation.⁹⁸

In recent years, many service providers (with Newco's consent) used the strategy of exchanging restricted stock for a deferred payment right shortly before the restricted stock was scheduled to vest. Such a transaction raises

⁹⁶For example, rather than specifying a date, the holder could elect to receive the shares only on the holder's separation from service, death, or disability.

⁹⁷Notice 2005-1, section IV.A, Q&A 4(e).

⁹⁸When the service provider receives unvested stock with no section 83(b) election and (while the stock is still subject to an SRF) receives dividend distributions treated as compensation for tax purposes under reg. section 1.83-1(a)(1), it is not wholly clear whether that compensation constitutes "deferred" compensation for section 409A purposes. This issue turns on whether (1) the service provider is viewed as receiving a legally binding right to the dividend in a year before the distribution and, (2) if so, whether that right is viewed as subject to an SRF (because the service provider would not have received the distribution if the unvested stock had been forfeited before the distribution).

⁹⁴Notice 2005-1, section IV.A, Q&A 4(d)(iv).

⁹⁵If deferral is mandatory rather than elective, the section 409A distribution trigger limitations, but not the section 409A election timing rules, apply to the RSU grant.

section 409A issues and structuring considerations similar to those discussed above regarding canceling an NQO and substituting a deferred payment right (that is, current income inclusion and taxation at a top federal tax rate of 55 percent).

VIII. Effective Date Issues

Except as described below, section 409A does not apply to an amount deferred and vested before January 1, 2005, unless the pre-January 1, 2005, deferral arrangement is materially modified after October 3, 2004, to add a new right or benefit for the service provider or to enhance any prior right or benefit.⁹⁹

Notice 2005-1 states that a deferred compensation arrangement is materially modified if any benefit or right is enhanced, or any new right or benefit is added, for the deferred compensation arrangement.¹⁰⁰ Also, Notice 2005-1 states that such enhancement or addition of a right or benefit is treated as a material modification of an arrangement even if it occurs at the employer's discretion under the terms of the arrangement, unless the discretion is exercised under the existing terms of the arrangement only (1) to change the time or manner of payment or (2) to change or add a notional investment measure.¹⁰¹ However, the exercise by a service provider of a right under an arrangement in existence on or before October 3, 2004, does not constitute a material modification of the arrangement.¹⁰²

Notice 2005-1 further states that adopting a new deferred compensation arrangement, or granting an additional benefit under an existing arrangement, after October 3, 2004, is presumed to be a material modification that causes the new arrangement or additional benefit to be subject to section 409A.¹⁰³ That presumption can be rebutted by demonstrating that the new arrangement or additional benefit is consistent with the employer's past practice (for example, an SAR grant under an

equity incentive plan under which the employer made periodic grants before October 3, 2004).

An amount is treated as deferred before January 1, 2005, only if both "earned and vested" by December 31, 2004.¹⁰⁴ Consequently, a deferred compensation arrangement granted before section 409A's October 2004 enactment may be subject to, and fail the requirements of, section 409A.

For example, an NQO issued before January 1, 2005 — indeed, an NQO granted, for example, in 2002 before any versions of section 409A began to appear in proposed legislation — is section 409A tainted if it is (1) in the money at grant and (2) not vested before January 1, 2005.

To alleviate that harsh result, Notice 2005-1 contains several relief provisions under which a deferred compensation arrangement that does not comply with section 409A may be modified or terminated without triggering the section 409A penalties (except that, for an arrangement termination, current income inclusion is required).¹⁰⁵ The following summarizes those provisions:¹⁰⁶

(1) Notice 2005-1 states that an arrangement adopted on or before December 31, 2005, does not violate section 409A's requirements — and therefore compensation deferred under the arrangement is not subject to section 409A's penalties — if the arrangement is (a) amended by December 31, 2005, to bring it into compliance with section 409A and (b) "operated in good faith compliance with the provisions of section 409A and [Notice 2005-1] during the calendar year 2005."¹⁰⁷

(2) Amending a deferred compensation arrangement to "[reduce] an existing benefit" does not constitute a "material modification" of the existing arrangement. Consequently, deferred compensation not otherwise subject to section 409A because it is grandfathered under the effective date provisions does not become subject to section 409A if the

⁹⁹The October 2004 legislative history and a portion of Notice 2005-1 suggest that compensation payable by an employer that uses a noncalendar tax year can be deferred under the old rules before the end of the employer's tax year beginning in 2004 (e.g., until June 30, 2005, in the case of an employer with a June 30 fiscal year). 2004 Conference Report at 737 ("The provision is effective for amounts deferred in taxable years beginning after December 31, 2004") and Notice 2005-1, section IV.D, Q&A 16(a) ("Section 409A is effective with respect to (i) amounts deferred in tax years beginning after December 31, 2004"). However, because the statute unambiguously states that the new rules apply to amounts deferred on or after January 1, 2005, and other portions of Notice 2005-1 reflect the same concept (e.g., "for purposes of determining whether section 409A is effective with respect to an amount, the amount is considered deferred before January 1, 2005 if...") Notice 2005-1, section IV.D, Q&A 16(b)), we suggest that service providers should not rely on the legislative history and Q&A 16(a) of Notice 2005-1 to reach a different result absent a clarifying IRS announcement. See Jobs Act section 885(d)(1).

¹⁰⁰Notice 2005-1, section IV.D, Q&A 18(a).

¹⁰¹*Id.*

¹⁰²*Id.*

¹⁰³Notice 2005-1, section IV.D, Q&A 18(b).

¹⁰⁴2004 Conference Report at 737; Notice 2005-1, section IV.D, Q&A 16(b).

¹⁰⁵Notice 2005-1 effective date relief provisions were issued under section 885(f) of the Jobs Act, which directed the IRS to issue regulations to permit an existing deferred compensation arrangement to be (1) terminated and fully paid out or (2) amended to conform with section 409A, in each case without tainting pre-October 4, 2004, deferrals under the arrangement.

¹⁰⁶An additional effective date relief provision, which expired March 15, 2005, and is therefore not discussed in the text, permitted a deferral election to be made on or before March 15, 2005, with respect to compensation for services performed on or before December 31, 2005 (even though that may have been after the beginning of the year to which the services relate), if the following requirements were satisfied: (a) the compensation was not paid and had not become payable as of the time the election was made, (b) the arrangement under which the compensation was deferred was in existence on or before December 31, 2004, (c) the deferral election was made under the terms of the arrangement in effect on or before December 31, 2005, and (d) the arrangement was amended to comply with, and is operated in a manner that complies with, section 409A. Notice 2005-1, section IV.D, Q&A 21.

¹⁰⁷Notice 2005-1, section IV.D, Q&A 19(a).

deferral arrangement is amended by, for example, eliminating a potential payment trigger. However, “a plan amendment or the exercise of discretion under the terms of the plan that enhances an existing benefit or right or adds a new benefit or right will be considered a material modification even if the enhanced or added benefit would be permitted under section 409A.”¹⁰⁸

If a deferred compensation arrangement that does not satisfy one or more of section 409A’s requirements — but would be grandfathered under section 409A’s effective date provisions absent a “material modification” — is amended (or employer discretion is exercised) in a manner that results in a “material modification” of the arrangement, compensation deferred under the arrangement is subject to section 409A’s penalties (20 points of additional tax, plus interest charges) *unless* the requirements described in (1) above are satisfied.

(3) Terminating an existing deferred compensation arrangement (including for amounts deferred before section 409A’s effective date) does not constitute a material modification (and therefore does not subject amounts deferred under the existing arrangement to section 409A’s penalties) if (a) the arrangement is terminated and *all* compensation deferred thereunder is distributed on or before December 31, 2005, and (b) *all* amounts deferred under the arrangement are included in the service provider’s income in the tax year in which the termination occurs.¹⁰⁹ The grouping rule (discussed in Part IV above) does not apply for purposes of this rule, so that, for example, terminating and distributing an account balance maintained for a service provider’s salary deferrals is not treated as a modification of the service provider’s separate account balance maintained for bonus deferrals.¹¹⁰

(4) A deferred compensation arrangement adopted on or before December 31, 2005, may be terminated in whole or *in part* for both pre-2005 and post-2004 deferrals without triggering section 409A’s penalties if (a) the arrangement is terminated during the 2005 calendar year and (b) the amounts subject to the terminated arrangement are included in the service provider’s income in the tax year in which the amounts are earned and vested.¹¹¹ A deferred amount for an arrangement terminated under this rule may be distributed on termination in 2005, or, if later, in the service provider’s tax year in which

the amount vests.¹¹² The grouping rule (discussed in Part IV above) does not apply for purposes of this rule.¹¹³

(5) Two special transition relief rules are provided for NQOs and SARs. First, an NQO or SAR that would otherwise be section 409A tainted may be cancelled and reissued until December 31, 2005, so long as (a) the new NQO or SAR complies with section 409A’s requirements (including that the strike price is not less than the FV of the underlying stock on the original grant date), (b) the reissued NQO or SAR covers the same number of shares as the original cancelled NQO or SAR, and (c) the reissued NQO or SAR provides no additional benefit to the holder (for example, longer exercise period) other than avoidance of section 409A taint.¹¹⁴

Second, an NQO or SAR that would otherwise be section 409A-tainted may be amended until December 31, 2005, so that the NQO or SAR complies with section 409A(a)(2)’s payment-trigger rules — see Part III.B above.¹¹⁵

(6) A deferred compensation arrangement subject to section 409A may be amended until December 31, 2005, to allow the service provider to make a new payment election without regard to the election-timing rule or impermissible-acceleration rule (see Parts III.B and C above).¹¹⁶ That surprisingly broad relief provision permits a service provider to, for example, lengthen or shorten the deferral of any deferred compensation subject to section 409A, such as a bonus vesting after December 31, 2004, and for which an existing deferral election has been made. However, that relief provision does not apply to deferred compensation not subject to section 409A.

(7) As discussed in Part III.A.1 above, performance-based compensation (that is, compensation for which a deferral election may be made no later than six months before the end of the performance measurement period, rather than having to be made before the beginning of the tax year to which the compensation relates) is defined broadly to include bonuses based on subjective performance measures.¹¹⁷ Unlike the election-timing rule (1), this taxpayer-favorable rule does not have a specific expiration date, but the notice states that the IRS anticipates defining performance-based compensation more narrowly in future guidance.

If, under an arrangement established before January 1, 2005, and not modified after October 3, 2004, assets to fund compensation that was deferred and vested before

¹⁰⁸Notice 2005-1, section IV.D, Q&A 18(a).

¹⁰⁹Notice 2005-1, section IV.D, Q&A 18(c).

¹¹⁰Notice 2005-1, section IV.D, Q&A 18(e).

¹¹¹Notice 2005-1, section IV.D, Q&A 20(a), as clarified by the IRS on January 5, 2005. However, a partial termination likely constitutes a “material modification” of the arrangement as defined in Notice 2005-1, section IV.D, Q&A 18(a), thereby causing the continuing portion of the deferral to be section 409A-tainted unless the terms of the continuing portion are amended to comply with section 409A (if the arrangement had not already been so compliant).

¹¹²Notice 2005-1, section IV.D, Q&A 20(b).

¹¹³Notice 2005-1, section IV.D, Q&A 20(d).

¹¹⁴Notice 2005-1, section IV.D, Q&A 18(d).

¹¹⁵Notice 2005-1, section IV.D, Q&A 19(c), as clarified by the IRS on January 5, 2005.

¹¹⁶*Id.*

¹¹⁷Notice 2005-1, section IV.D, Q&A 22.

January 1, 2005, are, after December 31, 2004, (1) set aside offshore or in an offshore trust or (2) set aside or required to be set aside on a change in the employer's financial condition, whether or not in each case the assets remain subject to the claims of the employer's general creditors, the arrangement apparently does not constitute a deemed funding event requiring current inclusion (as described in Part V above) and 55 percent OI tax, because section 409A applies only to "amounts deferred [and, under the legislative history, vested] after December 31, 2004."¹¹⁸

IX. Reporting and Withholding Requirements

Deferred compensation required to be included in income before paid under section 409A must be reported to the IRS and the service provider on Form W-2 or Form 1099 and is subject to income tax withholding.¹¹⁹ The income tax withholding rate for nonperiodic payments

¹¹⁸Jobs Act section 885(d)(1). However, the Technical Corrections Bill provides that the section 409A(b) deemed funding provisions (as described in Part V above) are effective on January 1, 2005, so that all compensation (whether earned before, on, or after December 31, 2004) deferred under such a preexisting set-aside arrangement would be section 409A-tainted — that is, subject to current inclusion and 55 percent OI tax — in 2005. The Technical Corrections Bill would require the IRS, within 90 days following the Technical Corrections Bill's enactment, to issue regulations granting a limited post-effective-date grace period for eliminating section 409A-tainted deemed funding arrangements from deferred compensation plans without triggering section 409A's draconian tax penalties.

¹¹⁹Section 3401(a) (as amended by the Jobs Act).

("supplemental wage payments") is 25 percent,¹²⁰ but, beginning with 2005, supplemental wage payments in excess of \$1 million during a calendar year are subject to income tax withholding at a 35 percent rate.¹²¹

Amounts properly deferred under section 409A also must be reported on Form W-2 or Form 1099 for the tax year the compensation is deferred (even though not included in the service provider's income), presumably in a separate box to be added to those forms.¹²²

X. Employer Deduction

Legislative history states that the deferred compensation statute "does not affect the rules regarding the timing of an employer's deduction for nonqualified deferred compensation."¹²³ Under those rules, the employer is normally entitled to claim a compensation deduction on the last day of the service provider's tax year in which the deferred compensation is taxable.¹²⁴ Accordingly, when a service provider's income inclusion for deferred compensation is accelerated because the deferred compensation arrangement fails to satisfy section 409A's deferral requirements, or because there is a deemed funding event, the employer's deduction should be accelerated correspondingly.

¹²⁰Jobs Act section 904(a).

¹²¹Jobs Act section 904(b)(1).

¹²²Section 6051(a)(13).

¹²³2004 Conference Report at 735.

¹²⁴Section 404(a)(5); reg. section 1.404(a)-12(b)(1). See *Ginsburg and Levin Treatise* at para. 1503.1.4.