

Designing Deferred Compensation Arrangements Under Section 409A: *Pitfalls and Penalties*

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Introduction to Section 409A

- History
 - American Jobs Creation Act of 2004
 - First round of guidance: Notice 2005-1
 - Second round of guidance: Proposed Treasury Regulations Sections 1.409A-1 *et seq.*

Prior Rules

- 2 ways to be taxed without receipt of income
 - **Constructive Receipt**
 - Unqualified right to receipt and no substantial risk of forfeiture or substantial restriction
 - Code Section 451
 - **Economic Benefit**
 - Promise to pay is secured or interest is transferable
 - Funded promise of payment
 - Code Section 83

Basic Requirements of 409A

- Timely election to defer
 - *As to exact time of payment or permissible distribution event*
 - *As to form of payment*
- No acceleration of payment
- Limited distribution rights
- No off-shore “unfunded” accounts
- Reporting obligations

Today's Agenda

- Key Concepts
- Deferral elections
- Distribution restrictions
- Equity-based compensation
- Other affected plans
- Next steps

Key Concepts

Key Definitions and Concepts

- Legally binding right to compensation
- Substantial risk of forfeiture
- Deferral of compensation
- Short-term deferral
- Performance-based compensation
- Material modification
- Plan aggregation

Legally Binding Right to Compensation

- Binding commitment to pay compensation in the future
 - Commitment can be conditional (“If you do *X*, I will pay you *Y*.”)
- Not lost due to offset, notional investment losses or decrease in regular compensation

Deferral of Compensation

- Compensation has not—
 - been actually or constructively received, or
 - been included in gross income
- Pursuant to the terms of the plan, the compensation is payable in a later year

Substantial Risk of Forfeiture

- Entitlement to benefits is conditioned on—
 - Performance of substantial future services by any person, or
 - Occurrence of a condition related to the purpose of compensation
 - Service provider's performance
 - Service recipient's business activities or organizational goals
- Possibility of forfeiture is substantial
- Not SROF: Noncompetition clauses, good reason (not categorically), rolling vesting, extended vesting

Compensation Subject to 409A

- Covered:
 - All types of deferred compensation, including salary or bonus deferrals, SERPs, excess benefit plans, severance plans, 457(f) plans and many types of equity compensation plans
- Exempt:
 - Qualified plans, 403(b) arrangements, 457(b) plans and certain welfare plans, time-off
- Exempt:
 - Amounts deferred and vested prior to 1/1/2005
 - But not if materially modified after 10/3/2004

Short-Term Deferrals

- Treated as payment within prior tax year
 - Amount must be paid by 15th day of 3rd month following end of tax year
- Plan design issue:
 - Defer in the year before the year in which the compensation is earned, not paid
 - Re-deferral can be based on short-term deferral rule

Performance-Based Compensation

- Performance period at least 12 months
- Contingent on individual or organizational performance criteria
- Goals not substantially certain to be met at time of election

Material Modification

- Grandfathered amounts:
 - Deferrals *earned and vested* on 12/31/2004, provided the plan is not materially modified after 10/3/2004
- Deferrals subject to cliff vesting or noncompetes *are not* earned and vested => not grandfathered
- Granting an option to terminate a deferral or plan participation is a material modification

Plan Aggregation

- By participant
 - One plan per participant in each plan category
 - Account balance plans
 - Non-account balance plans
 - Separation pay arrangements
 - Other plans

Teeth of Section 409A

- All amounts deferred under a nonqualified arrangement are included in taxable income currently unless—
 - Not vested or
 - Design and operation meet 409A
- Otherwise, amounts are subject to 409A penalties
 - Included in income 1st year of violation
 - plus underpayment penalty + 1%
 - plus penalty of 20% of taxable amount

Deferral Elections

Elections to Defer

- General rule:
 - Election must be made prior to the year in which the compensation is earned

Elections to Defer

- Exceptions to prior calendar rule:
 - Initial eligibility: 30 days after eligible, for compensation earned after election
 - Applies only once per plan category
 - Fiscal year compensation, if fiscal year is the basis for compensation
 - Election must be made prior to fiscal year
 - But salary deferrals still require 12/31 election

Elections to Defer

- **Evergreen elections**
 - Changes due by calendar year prior
- **Performance-based compensation**
 - Election must be made—
 - at least 6 months before the end of the performance period, and
 - while achieving goals is substantially uncertain or amount is unascertainable
 - Best practice is initial election
 - Monitor, communicate goals

Nonelective Arrangements

- Initial determination of time and form of payment = initial deferral election
- Plan design issue:
 - Specify time and form of payment prior to participant obtaining a legally binding right to the deferred compensation



Distributions

Distributions

- No payment of deferred compensation earlier than—
 - Separation from service
 - Date of disability
 - Death
 - Specified time
 - Change of control
 - Unforeseeable emergency

Permissible Delay in Payment

- Date of distribution can be objectively determinable date or year following a distribution event
 - **Payment can be made—**
 - By end of the calendar year within which date falls, or,
 - if later, by the 15th day of the 3rd calendar month following the date
 - **Similar to short-term deferral**

Separation from Service

- Termination of employment
 - If independent contractor, expiration of all service contracts
 - Death or retirement
- Other termination
 - Employment continues during a leave up to 6 months, longer if protected by contract or statute
- Safe harbor
 - Services and pay at 20% of average of last 3 years
 - Unless consulting which requires 50%

Key Employees – 6 Month Delay

- Publicly-traded companies
- Key employees determined on 12 month basis designated by employer
- Key employees are subject to 6 month delay
 - Delay applies to key employees following end of 12 month period that begins on the 1st day of the 4th month following the end of the identification period

Specified Time or Event

- Plan must provide for payment at a specified time or by schedule
 - Objectively determinable
 - Disregard acceleration except for death or disability
 - Date risk lapses can be a payment date
- If plan provides only for year of payment, it is deemed to be January 1 payment date for purposes of applying subsequent deferral rules

Disability

- Disabled
 - Unable to engage in any substantial activity by reason of medically determinable physical or mental impairment expected to result in death or a continuous period of at least 12 months, or
 - By reason of medically determinable physical or mental impairment expected to result in death or a continuous period of at least 12 months and receives replacement income under employer plan for at least 3 months
 - Can use Social Security definition

Change of Control

- Ownership:
 - Acquisition by person or group of 50% or more FMV or voting power of stock
- Effective control:
 - Acquisition by person or group of 35% or more FMV or voting power of stock
 - Majority of board members in 12 months not approved by 50% of board
- Ownership of substantial portion of assets:
 - Acquisition by person or group of 40% or more of gross FMV of assets in 12 months
- Objectively determinable

Change in Control (cont'd)

- Regulations only apply to corporations at this time
 - **Partnerships can comply by analogy**
 - Guidance will be issued under permissible acceleration provision of 409A
- Earn-outs meet 409A if payment schedule for equity based compensation is same as that applied to shareholders

Unforeseeable Emergency

- Qualifying events:
 - Medical
 - Casualty
 - Funeral
 - Related taxes (may qualify)
- Not qualifying events:
 - College tuition
 - Home purchase
 - Expenses that can be satisfied from other sources

Multiple Payment Events

- Plan may provide for payment at “earlier of,” or “later of,” 2 or more permitted events or times,
- Different form of payment may be elected for each
- Good flexibility in design and operation

Delay For Legal Compliance

- Play may provide for payment delay to avoid—
 - Loss of deduction under 162(m)
 - Payment would violate securities or other law
 - Payment would violate loan covenant or contract term
- Only minimum delay needed is allowed
- Partial payments not required
- Can add provision if not effective for 12 months
- Cannot remove from a plan

Anti-Acceleration Rules

- Cannot accelerate payment
 - Haircuts prohibited
 - Not applicable to waiver of condition
- Exceptions
 - Taxes due
 - FICA
 - 457(f)
 - If not 409A compliant
 - Domestic relations orders
 - De minimus payments
 - Up to \$10,000

Permissible Plan Termination

- At discretion of sponsor if—
 - Pursuant to plan terms
 - Termination applies to specific category of deferred compensation
 - All similar arrangements are terminated as to all participants
 - Only otherwise allowable payments can be made within 12 months of termination
 - All payments made within 24 months
 - Similar plan is not adopted for at least 5 years

Permissible Plan Termination

- Plan may provide that—
 - It may be terminated during the 12 months following a change of control
 - It will terminate on corporate dissolution or upon bankruptcy court approval

Suspension of Deferral Elections

- Plan may provide that deferral elections are suspended following emergency distributions or to obtain a hardship distribution from a 401(k) plan

Changes in Time or Form

- Subsequent deferral election or change in form of payment (“re-deferrals”) may be permitted
 - May not take effect for 12 months
 - Must defer first payment for at least 5 years from when it would have been made
 - Not applicable to distributions on death, disability, unforeseeable emergency
 - May not be made less than 12 months from when first payable
 - Applies to payment as of specified date or on a fixed schedule

Subsequent Deferral Election for Installments

- Plan may provide for treating installments as a single payment or each installment as a separate payment
 - In first situation, a lump sum distribution is permissible after 5 years
 - In second situation, a lump sum distribution is permissible 5 years after last installment would be due

Subsequent Deferral Election for Annuities

- Life annuities are always treated as a single payment

Equity-Based Plans

Equity Based Compensation

- Presumption is that equity-based compensation (options, SARs and other “stock rights”) is subject to 409A
 - Notice 2005-1 exempted Restricted Stock and Options granted at full Fair Market Value (ISOs and NQSOs) but left open question of Stock Appreciation Rights
 - Number of shares fixed at grant
 - No income deferred beyond exercise of option
 - Stock is “service recipient stock”
 - Regulations confirm and broaden exceptions to include SARs

Stock Appreciation Rights

- Only SARs issued by publicly traded companies that were settled in stock were exempt under Notice 2005-1
- Under regulations, SARs of all companies, whether public or private, and whether settled in cash or stock, will be exempt if—
 - **Granted at full FMV**
 - **No opportunity for further deferral *and***
 - **There is no “premium” paid at settlement**

Discounted Stock Rights

- Stock Rights issued at a discount are subject to the Section 409A rules; the element of “deferral” is the amount of the discount where the spread is not recognized until exercise
 - Fewer companies will issue discounted stock rights *but*
 - If issued, election and distribution restrictions appear to apply, requiring exercise at vesting or within short term deferral period.

Dividend Rights

- Dividend rights are subject to Section 409A
- The regulations clarify that the right to receive previously declared dividends on shares underlying exercised options or SARs is regarded as an offset against the exercise price (thus making it similar to a discounted option or SAR)
- Regulations indicate ability to grant rights separately, but then 409A compliance required.
 - Practically, rules require an election of a specified time and not an event so linking to exercise is not feasible). Link to vesting date or use short term deferral rule.

Restricted Stock Units

- RSUs are exempt from 409A, if the stock or cash will be issued within the Short Term Deferral Rule (payment made within 2 ½ months following close of year in which vesting occurs).
- RSUs are subject to 409A if the award provides for settlement after the short term deferral period.
- Special rules for 409A compliance:
 - Participant must make compliant deferral election within 30 days of date of award (like newly eligible participant); and
 - Initial vesting of the award cannot occur before 13 months following the date of award

Phantom Stock

- Subject to 409A general rules
- If vesting based on satisfaction of performance criteria, then considered “performance based” and deferral election may be made prior to the last 6 months of the measurement period

Earn Outs

- Compensation paid to a selling individual based on stock or stock rights upon a change in control (an “earn out”) will be compliant with the 409A distribution rules if—
 - Paid on the same schedule and under the same terms and conditions as payments made to all shareholders (or the company) involved in the change in control; and
 - Payments are made within 5 years of the change in control
- Treated as paid at a specified time or pursuant to a fixed schedule
- Flexible enough to permit most acquisitions to comply

Modification of a Stock Right

- Modification of a Stock Right is—
 - Any change in the terms of the right that will reduce the exercise price
 - Addition of a deferral feature; or
 - Extension or renewal of the right
- Exceptions to Modification:
 - If exercise extended only to later of end of year or within 2 ½ months of date of initial expiration
 - If vesting is accelerated
 - Addition of allowing payment with previously-owned shares
- Consequences of Modification:
 - Date of Modification is new grant date against which FMV of stock right must be measured (similar to ISO rules)

Valuation of Stock Underlying Stock Rights

- Notice 2005-1 stated that “any reasonable method” was permitted in valuing stock
- Regulations go into detail about methods and link it to status of company as publicly traded, private or “start up”
- “Start up” company is defined as—
 - One that has been in business fewer than 10 years;
 - Has no securities traded on an established market; and
 - Does not expect an IPO or CIC in the 12 months following the valuation date

Valuation: Publicly Traded Companies

- Several dates permitted to establish value:
 - Last sale prior to grant
 - First sale following grant
 - Closing price before or of date of grant
 - Average of stock price over 30 days before or after date of grant (so long as stated at time of grant)
 - Other method based on actual reported transactions if applied consistently

Valuation: Privately Held Companies

- “Safe Harbor” Methods:
 - Independent Appraisal (ESOP qualifications)
 - Use of Formula (if also used for non-compensatory reasons)
- Presumptively Unreasonable:
 - Valuation over 12 months old
 - Method that ignores information that has changed since last valuation

Valuation: Privately Held Companies (cont'd)

- Facts & Circumstances; Factors Test
 - Value of Company's Assets
 - Present Value of Future Cash Flow
 - Market Value of Stock of other Similar Companies involved in Similar Enterprise
 - Existence of Control Premium, Lack of Marketability Discounts
 - Use of Method for other Business Purposes that have a “material economic effect” on the Company

Valuation: Start Up Companies

- Factors used same as Privately Held Companies
- Presumption is different: Method is presumed reasonable if—
 - Made reasonably and in good faith
 - Evidenced by a written report
 - Valuation made by person with knowledge and experience

Definition of “Service Recipient Stock”

- Stock rights may be granted only to individuals that provide services to “service recipients.” There is a nexus required between the two.
- Generally, a 50% common ownership is required where individuals perform services for an entity that is not the entity granting the stock right
 - vs. “controlled group” concept
- Joint ventures require only a 20% common ownership, if there is a “legitimate business purpose” for the granting of the stock right (previous employment relationship is specifically permitted)

Definition of Service Recipient Stock (cont'd)

- Rights must be for common stock, no preference for dividends or liquidation. Can be ADR or mutual company unit.
- Substitution/Assumption of stock right in acquisition not treated as grant of new stock right or change in form of payment
- Grandfather rule for stock rights issued prior to 12/31/04

Non-Corporate Entities

- Regulations reserve comment on a variety of issues relating to non-corporate entities such as partnerships and LLCs, including valuation issues, relationships between entities, and the definition of a “change in control”
- Treasury and IRS have requested comments. Partnerships may rely on the existing rules by analogy until guidance is issued.

Other Affected Plans

457(f) Plans

- 409A adds an extra layer
- 457(f) SROF
 - Commonly applied to salary deferrals
- 409A SROF
 - Previously vested amounts (salary) cannot be subject to SROF
 - Noncompete is not a SROF
 - Rolling vesting is not a SROF

457(f) Plans

- 457(f) deferral
 - Includes amounts that are not deferrals under 409A, such as—
 - Right to future payments, even if payments are made immediately upon vesting
 - Undiscounted stock options
- 409A deferral
 - Includes severance pay arrangements
- Plan design issues:
 - Rolling vesting on re-deferral schedule?
 - Payment can be accelerated to extent necessary to pay taxes due to 457(f) failure

Separation Pay Arrangements (SPAs)

- Certain exempt involuntary SPAs:
 - Arrangements for 2 x compensation paid over 2 years
 - Lesser of 2 times annual compensation and 401(a)(17) limit (\$220,000 for 2006); and
 - Full payment by end of 2nd calendar year
 - Short-term deferrals
 - 15th day of the 3rd month following the service provider's or recipient's first tax year of separation
 - Collectively-bargained arrangements

Other Exempt SPAs

- “Involuntary” includes window programs
 - Short-term incentives for separation from service by identified group of service providers
- De minimis separation benefits
 - Payments do not exceed \$5000 in aggregate
- Reimbursement related to separation from service
 - Reimbursements incurred and paid by 12/31 of the 2nd year following year of separation

Non-Exempt SPAs

- Voluntary SPAs:
 - No exemption
 - Same as nonqualified deferred compensation plan that pays upon separation from service
 - SPAs for separation for “Good Reason”
 - No SROF
 - Issue with “double triggers,” i.e., Change in Control followed by separation for good reason

Linked Plans

- Coordinated with a qualified plan
 - Replace over-limit qualified plan benefits
 - Linked plan deferrals directly affected by qualified plan actions
- No 409A violation for establishment, amendment or operation of qualified plan
 - If no effect on time or form of payment under nonqualified plan
- If election of time and form of linked plan payment was based on qualified plan election, make separate election by 12/31/2006

Next Steps

Compliance with 409A

- If a deferral plan meets all 409A requirements, then regular tax rules apply
- Regular tax rules:
 - Taxable employers:
 - Benefits are taxed when actually or constructively received
 - Tax-exempt and governmental employers:
 - Benefits are taxed when they are no longer subject to 457(f) SROF

Violation of 409A

- If a deferral plan fails any 409A requirement, then 409A taxation and penalties apply
- 409A taxation and penalties:
 - Benefits are taxed as soon as any 409A SROF lapses
 - When taxed, benefits incur a 20% penalty
 - Participant pays interest (penalty rate) on the taxes that, absent the deferral, would have been paid in the year of deferral

Deadlines

- 1/1/2005:
 - Plans must be administered in accordance with a good faith interpretation of Section 409A
 - Includes Notice 2005-1
 - Notice was more restrictive than proposed regulations in some cases
 - Complying with proposed regulations is optional, but is deemed to be good faith compliance with 409A

More Deadlines

- 12/31/2005:
 - Deadline for plan terminations
 - Deadline for revocation of 2005 deferral elections
 - Deadline for exercise of discounted options, SARs
 - Deadline to elect to defer 2006 compensation
 - Deadline to rescind amendment made since 10/3/2004 that is a material modification

And More Deadlines

- 12/31/2006:
 - Plan amendment deadline
 - Deadline for special election of time and form of distribution

Next Steps

1. Ensure compliance now (for all of 2005)
2. Identify any plans to be terminated or 2005 deferral elections to be revoked by 12/31/05
3. Then enjoy 2005 holidays!
4. Analyze impact of 409A on existing plans
5. Develop schedule for adopting necessary plan amendments in 2006
6. Consider permitting new distribution elections for amounts subject to 409A by 12/31/06

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