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THE NEW REALITY: THE WAR ON DEFERRED COMPENSATION - HOW TO LIVE WITH THE NEW SECTION 409A RULES

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THE NEW REALITY: THE WAR ON DEFERRED COMPENSATION – HOW TO LIVE WITH THE NEW SECTION 409A RULES

In general, the objective of a nonqualified deferred compensation plan is to permit an employee to defer the date on which he is taxed. The deferral itself constitutes a tax advantage. A further advantage is obtained if the benefits provided under the plan are ultimately taxed at a lower tax rate either because rates have decreased or because the individual has lower taxable income, greater deductions, or other decreases in total taxes.

In order for a nonqualified deferred compensation plan to achieve its objective, the employee should not be taxed until the date the employee actually receives cash benefits under the plan. Deferring taxation until the benefits are paid also permits the employee to pay taxes with the funds received. If the employee had to pay taxes before receiving the benefits, he would have to use another source of funds to pay the taxes.

Congress, in the American Jobs Creation Act of 2004 ("AJCA")[1] enacted sweeping legislation that supplemented long standing general tax principles governing the timing of taxation of deferred compensation. Section 885 of the AJCA added a new Section 409A to the Internal Revenue Code (the "Code"), which imposes substantial additional requirements relating to the timing of deferral elections, the timing of the distributions of deferred compensation, prohibitions against acceleration of the payment of deferred compensation and certain restrictions on the use of foreign rabbi trusts and the use of financial health triggers in funding deferred compensation (including in funding rabbi trusts). In addition, Code Section 409A and IRS guidance issued under Code Section 409A[2] expansively defines deferred compensation to include types of compensation that historically have not been considered deferred compensation.

If a deferred compensation arrangement does not meet the requirements of Code Section 409A, the recipient of such deferred compensation will be subject to accelerated taxation on the deferred compensation and substantial additional tax penalties.

The new requirements imposed under Code Section 409A generally apply to amounts deferred under a nonqualified deferred compensation arrangement on or after January 1, 2005.[3] The new rules also apply to amounts deferred under a nonqualified deferred compensation

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[1] The AJCA was signed into law on October 22, 2004.

[2] On December 20, 2004, the Treasury Department and the IRS released Notice 2005-1, which provided preliminary guidance and transition guidance under Code Section 409A. On September 29, 2005, the Treasury Department issued proposed regulations under Code Section 409A. The proposed regulations generally incorporate and expand upon the guidance issued under Notice 2005-1 but also provide substantial additional guidance not found in Notice 2005-1. The proposed regulations do not affect the applicability of Notice 2005-1, which is expected to remain in effect until final regulations become effective. No final regulations under Code Section 409A have been issued as of the date of this writing.

[3] The Conference Report on AJCA provides that an amount will be considered deferred prior to January 1, 2005 only if it is earned and vested before such date. H.R. Conf. Rep. 108-755 at 723. See also Notice 2005-1, Q&A-16(b).

arrangement prior to January 1, 2005 if the arrangement is materially modified after October 3, 2004. In addition, the IRS has provided broad transition relief that is intended to allow service providers and service recipients to either terminate existing arrangements that fail to meet the new requirements or modify such arrangements to conform with the new requirements.[4]

The new deferred compensation rules under Code Section 409A apply in addition to other long-standing principles that govern the taxation of nonqualified deferred compensation. Two general tax principles have long governed the taxation of compensation deferred - the constructive receipt principle and the economic benefit principle. These principles are often confused and interrelated both in administrative pronouncements (e.g., regulations, rulings, GCMs), and in court decisions. A clear understanding of each and the difference between the two is essential to a proper analysis of whether a particular nonqualified deferred compensation plan achieves its objective of tax deferral.

The constructive receipt doctrine states that [i]ncome although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so he could have drawn upon it during the taxable year if notice of intent to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.[5]

The constructive receipt doctrine, simply stated, is that, if an employee has the right to receive income which is not subject to a substantial risk of forfeiture or other substantial restriction, the employee is taxed on such income on the date that right first arises.

From the IRS' perspective, this is important in preserving the symmetry between when the employee is taxed and when the employer is entitled to a tax deduction. Under the constructive receipt doctrine, the earlier the constructive receipt, the earlier the date on which the employee has taxable income. Generally, an employer may claim a tax deduction when the

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[4] Notice 2005-1 provides a transition period through December 31, 2005 during which pre-existing and new deferred compensation arrangements may be modified to conform with the new requirements or terminated. The proposed regulations under Code Section 409A extend the transition period for amending pre-existing and new deferred compensation arrangements to conform with the new requirements until December 31, 2006 but did not extend the period for terminating pre-existing and new arrangements adopted on or before December 31, 2005. Ongoing delays in releasing final regulations has put increasing pressure on the Treasury to further extend the transitional relief beyond December 31, 2006 and Treasury officials have informally indicated that they realize that that companies and their advisors will need time to digest the final regulations and revise existing compensation arrangements to comply with the final regulations.

[5] Treas. Reg. § 1.451-2(a).

employee has taxable income.[6] Thus, the employer should also be concerned about whether an employee is in constructive receipt.

From the employer's perspective, if an employee is determined to have taxable constructive receipt in a tax year earlier than the tax year in which he actually receives the benefit, a claimed employer deduction in the year of payment would be disallowed. In addition, if the earlier tax year is a tax year of the employer that is closed by the statute of limitations, then the employer will never be able to take a deduction for the benefit it gave to the employee.

The economic benefit doctrine is set forth in various judicial decisions and is now codified in Code Section 83 of the Code and Treasury Regulation Section 1.83-3. This regulation provides that "a transfer of property occurs when a person acquires a beneficial ownership interest in such property (disregarding any lapse restriction, as defined in [Treasury Regulation] § 1.83-3(i))."[7] In other words, an employee could receive a transfer of a property right with a determinable value regardless of whether that property right has been reduced to cash. In effect, the employee receives taxable property in exchange for services. This results in recognition of income under the economic benefit doctrine, provided that the employee's right to the transferred property is not subject to a substantial risk of forfeiture.[8]

In order to understand the important considerations affecting the design of nonqualified deferred compensation plans, one must first have a firm grasp on the general rules dealing with the constructive receipt and the economic benefit doctrines as well as the applicable statutory provisions of Code Sections 83, 402(b) and 451, as well as the new rules under Section 409A.

Subsection I below discusses in detail the new requirements imposed on amounts deferred on or after January 1, 2005 under Code Section 409A, Section II discusses traditional constructive receipt principles and Section III discusses the economic benefit principles.

I. Code Section 409A -- The New Tax Regime for Nonqualified Deferred Compensation

Code Section 409A was enacted in large measure to address certain abusive practices involving deferred compensation. For instance, shortly before Enron filed for bankruptcy protection, a small number of executives were allowed to withdraw their retirement funds from the company's non-qualified deferred compensation plan.[9] The result was that the company paid

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6 Code § 404(a)(5) (granting employer deduction for plan contribution at the time includable in employee's income, but if a plan benefits more than one employee, only if separate accounts are maintained). See Treas. Reg. § 1.404(a)-12(b)(3).

7 Treas. Reg. § 1.83-3(a).

8 See generally Code § 83; Treas. Reg. §§ 1.83-1 - 1.83-8.

9 David Barboza, *Enron's Many Strands: Executive Compensation; Enron Paid Some, Not All, Deferred Compensation*, N.Y. TIMES, Feb. 13, 2002.

millions of dollars to certain key employees with respect to previously deferred salary and bonuses.[10] Under Enron's deferred compensation plan, employees were allowed to remove their money at an earlier date (*i.e.*, on the eve of bankruptcy) and forfeit 10 percent of their deferred compensation. This 10 percent forfeiture is frequently referred to as a "haircut." Given the choice between receiving nothing from the plan following bankruptcy (because the deferred compensation is an unsecured liability of the company) or taking the 10 percent haircut, the executives, not surprisingly, opted to take the immediate withdrawal with the haircut.

Another compensation practice used by Enron involved the deferral of stock option gains realized from stock-for-stock exercises of options.[11] As part of the congressional investigation of Enron, it was acknowledged that such deferral programs are commonly used. However, it was also noted that there was no clear authority addressing stock option gain deferrals.

In passing Code Section 409A, Congress sought in large measure to prevent compensation practices involving deferred compensation that Congress perceived as abusive such as those engaged in by Enron. Moreover, there was a growing sense in Congress that service providers should not be permitted to manipulate the timing of taxation of compensation to the extent previously permitted.

A. Overview

Code Section 409A adds several additional requirements that overlay existing constructive receipt principles resulting in a completely new paradigm for the taxation of nonqualified deferred compensation. In order to avoid immediate taxation and tax penalties on service providers,[12] Code Section 409A imposes substantial additional restrictions on amounts deferred after January 1, 2005.

On December 20, 2004, the Treasury Department and the IRS released Notice 2005-1, which provided preliminary guidance and transition guidance under Code Section 409A. On September 29, 2005, the Treasury Department issued proposed regulations under Code Section 409A ("Proposed 409A Regulations"). The Proposed 409A Regulations generally incorporate and expand upon the guidance issued under Notice 2005-1 but also provide substantial additional guidance not found in Notice 2005-1. Although the Proposed 409A Regulations have a proposed effective date of January 1, 2007, Treasury has indicated in the preamble to the Proposed 409A

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10 *Id.*

11 Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues and Compensation Issues and Policy Recommendations, Joint Committee Print; 108th Congress, 1st Sess.: JCS-3-03, Feb. 2003.

12 Code Section 409A applies to a broad scope of service providers who are entitled to receive deferred compensation that is subject to Code Section 409A, including certain partnerships, corporations or other entities as well as common law employees. See Section I.D below. Accordingly, for purposes of this outline, individuals and entities that are entitled to receive compensation that may be subject to the requirements of Code Section 409A will be referred to as "service providers."

Regulations that they may be relied upon prior to the effective date of final regulations. The Proposed 409A Regulations do not affect the applicability of Notice 2005-1 which is expected to remain in effect until final regulations become effective.

In general, the new rules impose the following new restrictions on nonqualified deferred compensation:

(i) Deferral Elections. A service provider may elect to defer the receipt of compensation for services only if the election is made before the beginning of the year in which the services are performed. Certain exceptions apply in the first year of eligibility under the plan and to eligible performance based compensation.

A service provider may also make a "subsequent" deferral election with respect to amounts previously deferred if the subsequent deferral election is made at least 12 months before the compensation is otherwise payable and the deferral period is extended for a period of at least 5 years.

(ii) Distribution Restrictions. Deferred compensation may be distributed only on a predetermined fixed date or upon certain events (such as death, disability, termination of employment or change of control of the service recipient or payor of the deferred compensation).

(iii) Prohibition on Acceleration of Deferred Compensation Payments. Except in limited circumstances, the payment of deferred compensation may not be accelerated by agreement or otherwise.

(iv) Funding Restrictions. A taxable event under Code Section 409A will occur if a service recipient transfers assets to an offshore trust (even if the trust is otherwise subject to the claims of the service recipient's creditors) used for purposes of paying deferred compensation.

Likewise, a taxable event will occur under Code Section 409A if the service recipient transfers property or funds a trust (including a trust that is otherwise subject to the claims of the service recipient's creditors) in connection with a change in the service recipient's financial condition.

The recently enacted Pension Protection Act of 2006 further amended Code Section 409A to provide that a taxable event will occur if any assets are set aside or reserved in a trust to fund nonqualified deferred compensation (or if a nonqualified deferred compensation plan provides that any assets will become restricted to the payment of nonqualified deferred compensation) while any qualified defined benefit plan maintained by the plan sponsor or any member of its controlled group is in "at risk status," while the plan sponsor is a debtor in bankruptcy or at any time during the 12 month period beginning 6 months prior to the termination of any qualified defined benefit plan maintained by the plan sponsor or any controlled group member with insufficient assets to pay all of its benefit liabilities.

B. Taxes Imposed Due to Violation of the Section 409A Requirements

If a deferred compensation plan fails to satisfy the deferral election, distribution timing or prohibited acceleration requirements under Code Section 409A(a) (whether in form or in operation), all amounts subject to Code Section 409A[13] will be includable in the gross income of the service provider with respect to whom the violation relates to the extent that such deferred compensation is not subject to a substantial risk of forfeiture[14] and has not previously been included in income.

Likewise, Code Section 409A(b) provides that a transfer of property in connection with the performance of services for purposes of Section 83 will be deemed to occur if (i) any assets are directly or indirectly set aside in a trust or similar arrangement located outside of the United States for purposes of paying benefits under a nonqualified deferred compensation plan,[15] (ii) if a nonqualified deferred compensation plan provides that assets will become restricted to the provision of benefits under the plan in connection with a change in the employer's financial health[16] or if assets are set aside or reserved in a trust to fund nonqualified deferred compensation (or if the nonqualified deferred compensation plan provides that assets will become restricted to the payment of benefits under a nonqualified deferred compensation

13 There is no guidance as to what amount should be included in income under Code Section 409A in the context of stock appreciation rights and stock options that do not satisfy the requirements of Code Section 409A. The amount included in income could be determined based on an option pricing model such as Black-Scholes or the binomial model or it may be determined based on the intrinsic value of the stock options and stock appreciation rights (i.e., the excess of the fair market value of the underlying stock over the exercise price). Neither Notice 2005-1 nor the Proposed 409A Regulations include any guidance with respect to this issue.

14 See Section I.C.2 below for a description of when an amount is subject to a substantial risk of forfeiture for purposes of Code Section 409A.

15 Code § 409A(b)(1). The transfer of property under this provision will be treated as occurring (i) at the time such assets are set aside in the trust or similar arrangement if the assets are located outside of the United States or (ii) at the time such assets are subsequently transferred outside of the United States. This rule applies even if the assets remain available to satisfy the claims of general creditors of the service recipient. This rule does not apply, however, to assets located in a foreign jurisdiction if substantially all of the services to which the nonqualified deferred compensation relates were performed in such foreign jurisdiction. Id. Although the Proposed 409A Regulations do not address this funding issue, they do provide guidance on the application of Code Section 409A to foreign deferred compensation arrangements. See § I.C.7 below.

16 Code § 409A(b)(2). The transfer of property under this provision will be treated as occurring (i) on the date on which plan first provides that assets will become restricted to the provision of benefits under the plan in connection a change in the service recipient's financial health or (ii) the date on which assets are so restricted, whether or not the assets remain subject to the claims of the employer's general creditors. Id. The Conference Report indicates that this provision is not intended to apply where assets are restricted for reasons unrelated to the employer's financial health (such as upon a change of control) or where assets are restricted pursuant to a structured schedule and a scheduled restriction happens to coincide with a change in the employer's financial condition. H.R. Conf. Rep. 108-755 at 720.

arrangement) while any defined benefit plan maintained within the employer's controlled group is "at-risk," while the employer is a debtor in bankruptcy, or during the 12 month period beginning 6 months before the termination of a defined benefit plan within the employer's controlled group if the plan does not have sufficient assets to pay its benefit liabilities.[17] For each taxable year thereafter, the increase in the value of, or earnings on, assets treated as transferred for purposes of Section 83 under Code Section 409A(b) will be treated as an additional transfer of assets.[18]

If any compensation is required to be included in income under Section 409A(a) or (b), the amount of tax payable by the service provider will be further increased by the sum of:

(i) interest at the underpayment rate plus 1% on the underpayments that would have occurred had the nonqualified deferred compensation been includible in gross income in the year in which such compensation was first deferred (or, if later, no longer subject to a substantial risk of forfeiture) plus

(ii) an additional 20% of the amount of compensation required to be included in income.

Code § 409A(a)(1)(B) and (b)(5). If the employer pays a tax gross up payment to the CEO or one of the 4 other highest paid executive officers or an individual subject to Section 16(a) of the Securities Exchange Act of 1934 (a "covered employee") with respect to any amount includable in a person's gross income as a result of funding nonqualified deferred compensation while a defined benefit plan is "at risk," while the employer is in bankruptcy or during the 12 month period beginning 6 months before the termination of a qualified defined benefit plan maintained by employer or any controlled group member if the plan does not have sufficient assets to pay its benefit liabilities, the tax gross up payment will be subject to the interest payment and 20% penalty tax as if it were part of the deferred compensation to which it relates and the employer will not be permitted to a deduction for such tax gross up payments.[19]

In the case of violations under Code Section 409A(a), the taxes, penalties and interest are assessed with respect to all amounts deferred under the "plan." There are two important concepts that apply in determining the amounts deferred under the plan for purposes of determining the amount of taxes, penalties and interest due upon violation of the requirements of Code Section 409A(a). First, Code Section 409A is applied as if one or more separate plans are

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[17] Code § 409A(b)(3). The acceleration of taxes, tax penalties and interest do not apply to assets that are transferred to a trust or reserved to the payment of nonqualified deferred compensation prior to the beginning of the restricted period. Id.

[18] Code § 409A(b)(4).

[19] Code § 409A(b)(3)(C).

maintained for each service provider. Second, all deferred compensation plans of the same type (there are four different types of deferred compensation plans) are treated as a single plan.

1. Separate Plans for Each Service Provider

The requirements of Code Section 409A are applied as if a separate plan is maintained for each service provider.[20] Thus, a violation of the requirements of Code Section 409A with respect to one service provider may not necessarily subject other service providers to taxes, penalties and interest under Code Section 409A. For this purpose, however, a distinction between operational violations and form violations may be critical.

A form violation (i.e., a documentary violation) will result in acceleration of taxes, penalties and interest under Code Section 409A for all service providers to whom the form defect applies. For instance, if a deferred compensation arrangement is amended to accelerate distributions for employees of subsidiary A but not for subsidiary B, all employees of subsidiary A would be subject to the taxes, penalties and interest imposed under Code Section 409A but employees of subsidiary B should not be affected.

An operational violation will generally apply only to the service provider who is affected by the operational violation. For example, if the terms of a deferred compensation arrangement comply with the requirements of Code Section 409A but a distribution is made to one service provider that is not permitted under the terms of the arrangement, that service provider would be subject to the taxes, penalties and interest under Code Section 409A but other service providers with deferred compensation under that arrangement should not be affected by the operational violation. However, repeated operational violations may evidence an intent to disregard the terms of the plan, in which case the IRS may treat the violation as a form violation affecting all service providers under the arrangement.

2. Plan Aggregation

All arrangements of a similar type are treated as single plan for purposes of applying the requirements of Code Section 409A. Thus, a violation under one arrangement would subject the service provider to taxes, penalties and interest with respect to the compensation deferred under all other arrangements of the same type that are maintained by the service recipient.

Each service provider may be treated as participating in as many as four different types of deferred compensation plans that may be subject to Code Section 409A: (i) account balance plans, (ii) nonaccount balance plans (such as defined benefit arrangements), (iii) separation pay plans, and (iv) all other plans (which may include discounted stock options and stock appreciation rights and certain other equity-based compensation).[21] Thus, if a service recipient maintains a deferred cash bonus arrangement, 401(k) excess plan and a defined benefit SERP, an

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[20] Notice 2005-1, Q&A-9; Prop. Treas. Reg. § 1.409A-1(c)(1).

[21] Notice 2005-1, Q&A-9; Prop. Treas. Reg. § 1.409A-1(c)(2).

employee who benefits under all three arrangements will be treated as participating in two separate deferred compensation plans for purposes of Code Section 409A: (i) an account balance plan consisting of the deferred cash bonus arrangement and 401(k) excess plan, and (ii) a nonaccount balance plan consisting of the defined benefit SERP. If a form or operational violation occurs with respect to the service provider under the cash bonus arrangement, all of the service provider's deferred compensation under the deferred cash bonus arrangement and under the 401(k) excess plan would be subject to acceleration of taxes, penalties and interest under Code Section 409A but the amounts deferred under the defined benefit SERP would be unaffected by the violation.

Note that the plan aggregation rules do not aggregate plans of a similar type if the service provider participates in one set of arrangements as an employee and a separate set of arrangements as a non-employee service provider (e.g., a corporate director or independent contractor). This provision may apply when an individual changes status (e.g., an independent contractor becomes an employee) or if an individual provides services simultaneously in two different capacities (e.g., as an employee and as a corporate director). Thus, if an employee-director receives deferred compensation under one plan maintained for directors and under another plan of a similar type maintained for employees, the two arrangements will not be aggregated.[22]

C. Definition of Nonqualified Deferred Compensation

The types of arrangements and the service providers that are subject to Code Section 409A is extremely expansive. Depending on the terms of the arrangement, Code Section 409A may apply to certain compensation arrangements that have not previously been treated as deferred compensation including stock options, restricted stock or other restricted property, annual and long-term bonus plans and even severance plans. Code Section 409A generally applies to all amounts deferred on or after January 1, 2005.[23]

Notice 2005-1 and the Proposed 409A Regulations provide that a service provider will have deferred compensation for purposes of Code Section 409A if (i) he has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in income and (ii) under the terms of the plan the compensation is payable to (or on behalf of) the service provider in a later year.[24]

The determination of whether a service provider has a "legally binding right" to compensation is based on the relevant facts and circumstances. For example, if an incentive plan provides for the payment of a bonus in an amount determined pursuant to a formula based on the achievement of objectively verifiable criteria, the service provider will be treated as having a

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[22] Prop. Treas. Reg. § 1.409A-1(c)(2)(ii).

[23] See Section I.I below for a discussion of the grandfather rules.

[24] Notice 2005-1, Q&A-4(a); Prop. Treas. Reg. § 1.409A-1(b)(1).

legally binding right to the bonus. However, if the employer has the unilateral right to reduce the amount of the bonus or eliminate the bonus, the service provider will generally not have a legally binding right to the bonus. Notice 2005-1 provides, however, that if the right to reduce or eliminate the bonus is unlikely to be exercised or is available only upon the occurrence of a condition that is unlikely to occur, the service provider will be treated as having a legally binding right to the bonus.[25] In response to comments that this standard is too vague and requires subjective judgment, the Proposed 409A Regulations provide that a service recipient's right to unilaterally reduce or eliminate compensation will be disregarded only if the right is available or exercisable only upon a condition or if the discretion to reduce or eliminate the compensation lacks substantive significance.[26] Whether such discretion lacks substantive significance depends on the facts and circumstances but the Proposed 409A Regulation clarifies that discretion will lack economic significance if the service provider or a member of the service provider's family has effective control over the person who retains such discretion (e.g., as a principal owner of the service recipient).[27]

1. Short-Term Deferrals

A service provider will not be treated as having deferred compensation merely because the plan requires payment to the service provider within 2½ months after the end of the taxable year in which the service provider vests[28] in the compensation and the payment is actually or constructively received within that time frame. For this purpose, the "taxable year" refers to either the taxable year of the service provider or the service recipient, whichever ends later.[29] Although Notice 2005-1 provides that the plan must provide that the payment will be made within the applicable period, the Proposed 409A Regulations merely require actual or constructive receipt of the compensation within the specified period.[30]

2. Unvested Compensation

For purposes of Code Section 409A, compensation will be treated as unvested if the compensation is conditioned on the performance of substantial future services or the occurrence

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[25] Notice 2005-1, Q&A-4(a).

[26] Prop. Treas. Reg. § 1.409A-1(b)(1).

[27] Id.

[28] Code Section 409A uses the term "substantial risk of forfeiture." However, a substantial risk of forfeiture for purposes of Code Section 409A may be substantially different from a substantial risk of forfeiture for purposes of Code Sections 83 and 457(f). See Code Section 409A(e)(5) (authorizing the Secretary of Treasury to promulgate regulations disregarding a substantial risk of forfeiture). Accordingly, in order to distinguish a substantial risk of forfeiture under Code Section 409A from a substantial risk of forfeiture under Code Sections 83 and 457(f) for purposes of this outline, we will use the term "unvested" to describe compensation that is subject to a substantial risk of forfeiture for purposes of Code Section 409A.

[29] Notice 2005-1, Q&A-4(c); Prop. Treas. Reg. § 1.409A-1(b)(4).

[30] Id.

of a condition related to the purpose of the compensation and the possibility of forfeiture is substantial.[31]

A condition related to the purpose of the compensation must relate to the service provider's performance of services or to the service recipient's business activities or organizational goals (e.g., the attainment of a prescribed level of earnings, equity value or the occurrence of a liquidity event).[32] Thus, for instance a retention bonus that is paid only if an employee continues to work until a specified date should not be treated as deferred compensation if the payment is made during (or within 2½ months after the end of) the taxable year in which the employee vests in the bonus by working to the specified date. Similarly, a bonus payable upon the occurrence of an uncertain event such as the sale of a subsidiary or division or an initial public offering of the service recipient's stock or other organizational goals such as the attainment of a specified earnings target should not be treated as deferred compensation if the bonus is paid during (or within 2½ months after the end of) the year in which the vesting event occurs. However, an amount will not be treated as unvested merely because it is conditioned upon a service provider's refraining from the performance of services.[33] Thus, compensation will not be treated as unvested for purposes of Code Section 409A solely because it will be forfeited if the service provider violates a covenant not to compete with the service recipient.

If the vesting period is extended after the beginning of the service period to which the compensation relates, the risk of forfeiture will be disregarded for purposes of Code Section 409A unless the amount payable upon the later vesting date is materially greater (ignoring earnings) than the amount payable on the original vesting date.[34] Thus, amounts subjected to a risk of forfeiture pursuant to a salary reduction election will be treated as deferred compensation unless the amount subject to risk of forfeiture has a materially greater value than the amount that would have been paid absent the election. For instance, if a service provider is given a choice between $1,000 in cash or shares of restricted stock that is subject to a substantial risk of forfeiture and has a fair market value that is substantially greater than $1,000, the restricted stock would be treated as unvested for purposes of Code Section 409A and would not be subject to Code Section 409A. However, if the restricted stock had a fair market value of $1,000, the restricted stock would not be treated as unvested for purposes of Code Section 409A.

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31 Notice 2005-1, Q&A-10(a); Prop. Treas. Reg. § 1.409A-1(d)(1). Factors that are relevant in determining whether the possibility of forfeiture is substantial, include (among others): (i) the service provider's relationship to other equity holders and the extent of their control over the service recipient, (ii) the position of the service provider in the service recipient and the extent to which the service provider is subordinate to other service providers; (iii) the service provider's relationship to officers and directors of the service recipient, (iv) the persons who must approve the service provider's discharge and (v) the history of the service recipient in enforcing the vesting conditions. Notice 2005-1, Q&A-10(b); Prop. Treas. Reg. § 1.409A-1(d)(3).

32 Notice 2005-1, Q&A-10(a); Prop. Treas. Reg. § 1.409A-1(d)(1).

33 Id.

34 Notice 2005-1, Q&A-10(a); Prop. Treas. Reg. § 1.409A-1(d)(1).

It is important to note that the extension of the vesting period will not necessarily subject the compensation to taxation under Code Section 409A. For example, if the service provider makes an election to extend the vesting period at least 12 months before the original vesting date and the new vesting date is at least five years after the original vesting date, the extension of the vesting period should not, in and of itself, cause the compensation to fail to satisfy the requirements of Code Section 409A.

It is also noteworthy that the rules relating to the extension of the vesting period presents a substantial problem for tax-exempt entities. Under Code Section 457(f), deferred compensation payable by a tax-exempt entity will be taxable when such amounts are no longer subject to a substantial risk of forfeiture. In order to balance the goal of tax deferral with the need to avoid subjecting deferred compensation to lengthy vesting periods, tax-exempt entities have frequently provided employees with deferred compensation that is subject to relatively short vesting periods (2 to 5 years). As employees approach the vesting dates of these amounts, the employer and employee will often agree to extend the vesting period for an additional period of years. Typically, these arrangements will also provide for full vesting if the employee terminates employment due to death or disability or is actually or constructively discharged by the employer.

Under Notice 2005-1 and the Proposed 409A Regulations, the amounts deferred under a Code Section 457(f) plan will be treated as deferred compensation under Code Section 409A when the vesting period is first extended (unless the amount of compensation subject to the substantial risk of forfeiture is materially increased). Thus, in order to avoid accelerated taxation and penalties under Code Section 409A, the extension of the vesting period must satisfy the subsequent deferral election provisions under Code Section 409A(a)(4)(C), which requires the deferral period to be extended for a period of at least five years, unless the distribution is made on account of death, disability or upon the occurrence of an unforeseeable emergency. There is no exception to the five year extension for distributions upon termination of employment. Therefore, in order for an employee of a tax-exempt entity to extend the deferral period by extending the vesting period of his or her deferred compensation, the employee generally must subject the compensation to risk of forfeiture in the event he is actually or constructively discharged by the tax-exempt employer prior to the vesting date or the arrangement must provide for deferral of the payment of the deferred compensation for at least five years with accelerated vesting if the employee is actually or constructively discharged prior to the distribution date. This latter alternative, however, may have the undesirable effect of subjecting the employee to taxation of the deferred compensation under Code Section 457(f) before the deferred compensation may be distributed to the employee.[35] This will put tax-exempt employers at an

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[35] Note that Notice 2005-1, Q&A-15(d) and Prop. Treas. Reg. § 1.409A-3(h)(2)(iii) provide that the plan may permit an acceleration of the distribution of the deferred compensation under a Code Section 457(f) plan in an amount not to exceed the amount that the employer would have remitted in tax withholdings if the employer had paid wages to the employee in an amount equal to the amount included in the employee's income under Code Section 457(f) at the time the deferred compensation vested. Because the amount that may be accelerated is tied to the amount of taxes the employer is required to withhold rather than the amount of taxes payable by the service provider, this exception to the anti-acceleration requirements may result in a distribution in an amount that is less

...(continued)

even greater competitive disadvantage *vis a vis* taxable employers in attracting and retaining executive talent than prior to the enactment of Code Section 409A.

3. Stock Rights

(a) Stock Options. Notice 2005-1 and the Proposed 409A Regulations generally provide that a non-statutory[36] option to purchase stock of the service recipient will be treated as deferred compensation for purposes of Code Section 409A unless all of the following conditions are met: (1) the exercise price may never be less than the fair market value of the stock on the date the option is granted, (2) the option is subject to taxation under Code Section 83, and (3) the option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of the exercise or disposition of the option.[37] For this purpose, the right to receive restricted stock upon exercise of an option will not be treated as a deferral of compensation.[38]

Most stock options that fail to satisfy these conditions for exemption from Code Section 409A will also be unlikely to satisfy the requirements of Code Section 409A, since the option holder will generally be able to determine when to exercise a stock option and receive taxable income.

The guidance also effectively precludes arrangements that provide an option holder with a right to convert the option spread into deferred stock units or other deferred compensation, even if the deferred stock units would otherwise satisfy the requirements of Code Section 409A, because the inclusion of such a conversion right in a stock option will be treated as an additional deferral feature that causes the option to be treated as deferred compensation.[39]

(b) Stock Appreciation Rights (SARs). Notice 2005-1 also provides that an SAR with respect to stock of the service recipient will also be treated as deferred compensation for purposes of Code Section 409A unless the SAR provides (1) that the

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...(continued)
than the total amount of tax payable by the employee under Code Section 457(f). This would occur if the employee's effective tax rate exceeds the applicable withholding tax rate.

36 Statutory stock options (i.e., incentive stock options described in Code Section 422 and options granted under an employee stock purchase plan described in Code Section 423, including an option granted with an exercise price that is less than fair market value on the date of grant if the option satisfies the requirements of Code Section 423(b)(6)) are generally exempt from the requirements of Code Section 409A. See Notice 2005-1, Q&A-4(d)(iii); Prop. Treas. Reg. § 1.409A-1(b)(5)(ii).

37 Notice 2005-1, Q&A-4(d)(ii); Prop. Treas. Reg. § 1.409A-1(b)(5)(i)(A). The Proposed 409A Regulations add an additional requirement that the number of shares subject to the option be fixed on the original grant date of the option. Prop. Treas. Reg. § 1.409A-1(b)(5)(i)(A)(1).

38 Notice 2005-1, Q&A-4(d)(ii); Prop. Treas. Reg. § 1.409A-1(b)(5)(i)(A).

39 See Section II.F below for a discussion of the conversion of stock option gains into deferred compensation.

SAR exercise price may never be less than the fair market value of the stock subject to the SAR on the date the SAR is granted, (2) the stock of the service recipient that is subject to the SAR must be publicly traded on an established securities market, (3) the SAR must be settled in the form of publicly traded stock of the service recipient and (4) the SAR does not include any feature for the deferral of compensation (other than the deferral of recognition of income until exercise of the SAR.[40] An SAR will not be treated as deferred compensation merely because the service provider receives restricted stock upon exercise of the SAR.[41]

The Proposed 409A Regulations substantially expanded the exemption of SARs from Code Section 409A by eliminating the requirements that the service recipient stock subject the SAR be publicly traded and that the SAR be settled in the form of such publicly traded stock.[42]

(c) Stock of the Service Recipient. A stock right (i.e., a stock option or SAR) will not qualify for exemption from Code Section 409A (i.e., the stock right will be treated as deferred compensation) if the stock subject to the stock right is not "stock of the service recipient."[43] Although Notice 2005-1 provides little guidance on the meaning of stock of the service recipient, the Proposed 409A Regulations provides much more expansive guidance, which both expands and limits the availability of the exemption for stock rights.

In general, stock of the service recipient means stock of a corporation[44] that is a service recipient (including any member of a member of a group of corporations or other entities that are treated as a single service recipient as described below) that is readily tradable on an established securities market, or if no stock of the service recipient is readily tradable, that class of common stock of such corporation having the greatest aggregate value of common stock issued.[45] Preferred stock (i.e., stock which is preferred as to liquidation or dividend rights) and stock subject to a put or call right that is based on

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40 Notice 2005-1, Q&A-4(d)(iv).

41 Id.

42 Prop. Treas. Reg. § 1.409A-1b)(b)(1)(B). The Proposed 409A Regulations also added a new condition that the number of shares subject to the SAR must be fixed on or before the grant date. Id.

43 Notice 2005-1, Q&A-4(d)(ii) & (iv); Prop. Treas. Reg. § 1.409A-1(b)(5)(i)(C).

44 The Proposed 409A Regulations provide that American depository receipts or American depository shares (collectively, "ADRs") may qualify as service recipient stock to the extent the stock to which the ADRs relate is traded on a foreign securities market and otherwise qualifies as service recipient stock. Prop. Treas. Reg. § 1.409A-1(b)(5)(iii)(B). In addition, mutual company units may also qualify as service recipient stock. Prop. Treas. Reg. § 1.409A-1(b)(5)(iii)(C).

45 Prop. Treas. Reg. § 1.409A-1(b)(5)(iii)(A).

a measure other than fair market value of the stock subject to the put or call right may not be treated as service recipient stock.[46]

Although not entirely clear from the language of the Proposed 409A Regulations, Treasury officials have informally indicated that if one corporation within a controlled group has readily tradable common stock, common stock of other entities within the controlled group would not be treated as stock of the service recipient. This treatment would substantially restrict the ability to issue stock options and SARs with respect to the non-publicly traded common stock of a subsidiary of a publicly traded corporation.

Although the Proposed 409A Regulations limit the classes of stock that may be treated as stock of the service recipient, the regulations provide partial relief from this rule for stock rights granted on or before December 31, 2004. Under this relief any class of common stock of the service recipient will be treated as stock of the service recipient with respect to stock rights granted on or before December 31, 2004.[47] This relief is overly restrictive in that nothing in the legislative history of Code Section 409A or Notice 2005-1 suggested the narrow definition of stock of the service recipient proposed by Treasury in the regulations. Accordingly, many service recipients have been issuing stock rights since 2004 that are subject to common stock which may not qualify as stock of the recipient corporation.

The Proposed 409A Regulations also provide fairly flexible rules for determining which entities are treated as a single entity for purposes of determining the stock of the recipient corporation. Under the Proposed 409A Regulations, all entities under common control (using the employer aggregation rules contained in Code Section 414(b) and (c)) will be treated as single service recipient, except that the plan or arrangement may provide that ownership standard for control will be "at least 50 percent" rather than "at least 80 percent." Moreover, an even lower ownership threshold may be used (as low as 20 percent) if the use of such stock with respect to the grant of a stock right under the plan or arrangement is supported by legitimate business criteria. This rule is intended to allow a corporation that participates in a joint venture to grant stock rights with respect to its own stock to employees of a joint venture who are former employees of the corporation.[48]

The Proposed 409A Regulations also contain an anti-abuse provision, which provides that stock of a corporation whose primary purpose is to serve as an investment vehicle with respect to the corporation's interest in other entities may not be treated as stock of a service recipient with respect to any service provider (other than a service

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46 Id.

47 Prop. Treas. Reg. § 1.409A-1(b)(5)(iii)(E).

48 Prop. Treas. Reg. § 1.409A-1(b)(5)(iii)(D)(1).

provider who provides services directly to such corporation).[49] The preamble to the Proposed 409A Regulations suggests that this rules was intended to prevent the establishment of a corporation within a controlled group that is intended to serve as an investment vehicle for nonqualified deferred compensation. However, the language of the regulation itself is not so limiting and applies to any "corporation whose primary purpose is to serve as an investment vehicle in other entities." Read literally, this provision could apply to any holding companies that own interests in multiple corporations and other entities.

(d) Fair Market Value. The Proposed 409A Regulations provide quite helpful guidance with respect to the determination of fair market value for purposes of determining the exercise price for stock rights. With respect to service recipient stock that is readily tradable on an established securities exchange, the Proposed 409A Regulations provide some flexibility regarding the determination of fair market value of the stock on the grant date. The stock value may be determined based on any of the following: (i) the last sale before the grant, (ii) the first sale after the grant, (iii) the closing price on the last trading day before the grant date, or (iv) any other reasonable basis using actual transactions in the stock. In addition, the fair market value may also be determined based on the average sales price during a specified period that is within 30 days before or 30 days after the grant; provided that there is an irrevocable commitment made before the beginning of the valuation period to grant the stock right at an exercise price using this valuation method and this method is used consistently for grants of stock rights granted under the same and substantially similar programs.[50]

The Proposed 409A Regulations also provided helpful guidance for determining the fair market value of stock that is not readily tradable on an established securities market. In general , the Proposed 409A Regulations provide that fair market value of non-readily tradable stock as a valuation date is the value determined by the reasonable application of a reasonable valuation method taking into account the following factors, (i) the value of tangible and intangible assets, (ii) the present value of future cash flows, (iii) market value of the stock or equity interests in similar businesses (which value may be determined through objective means), and (iv) other relevant factors such as control premiums and marketability discounts.[51]

A stock value established using a reasonable valuation method may be used for a period of not more than 12 months after the value is established unless the value fails to

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49 Prop. Treas. Reg. § 1.409A-1(b)(5)(iii)(D)(2).

50 Prop. Treas. Reg. § 1.409A-1(b)(5)(iv)(A).

51 Prop. Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(1).

take into account material information not taken into account in the prior valuation that may materially affect the value of the stock.[52]

Moreover, in response to persistent criticism that Notice 2005-1 failed to provide sufficient valuation guidance on which service providers and service recipients could rely, the Proposed 409A Regulations provided a rebuttable presumption of reasonableness if the nonreadily tradable stock is valued using one of the following three methods:

(i) Valuation by an independent appraiser (consistent with the ESOP valuation requirements under Code Section 401(a)(28)) as of a date not more than 12 months prior to the relevant transaction (e.g., a stock option grant).

(ii) Valuation based on a formula (such as a multiple of earnings) that, if used as part of a nonlapse restriction (within the meaning of Treas. Reg. § 1.83-3(h)) would be considered to be fair market value for purposes of Code Section 83. This formula must be used to value the service recipient's stock for all purposes, including noncompensatory purposes. This restriction severely restricts the utility of this valuation method.

(iii) If the service recipient is an illiquid start up company (i.e., a company which has not conducted any trade or business for a period of 10 or more years and meets certain other requirements), a reasonable valuation made in good faith and evidenced by a written report that takes into account the valuation factors described above. The valuation must be performed by persons with significant knowledge and experience or training in performing such valuations.[53]

A valuation using one of these methods will be presumed to be reasonable unless the IRS can show that the valuation method used or the application of that method was grossly unreasonable.[54]

The IRS recently issued additional guidance in response to concerns over the retroactive application of Section 409A to stock rights granted prior to January 1, 2005.[55] While many issuers of stock options and stock appreciation may have attempted to

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52 Id.

53 Prop. Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(2).

54 Id.

55 Notice 2006-4.

establish an exercise price that was not less than fair market value at the time of grant, they may not be able to demonstrate compliance with this requirement. In many cases the stock rights may have been granted several years before enactment of Section 409A or the issuance of Notice 2005-1 or the Proposed 409A Regulations. Accordingly, at the time these stock rights were granted these issuers had no notice that they should have used any of the proposed valuation methods to establish fair market value of the stock. Notice 2006-4 provides that until further guidance is issued, the issuer of any stock rights granted prior to January 1, 2005 may apply principles similar to those set forth in Treasury Regulation 1.422-2(e)(2) (for incentive stock options) to determine the fair market value of the stock on the date of grant of the stock right.[56] The incentive stock option regulations generally require a good-faith attempt to set the exercise price at fair market value of the stock. Whether there was a good-faith attempt to set the exercise price at fair market value for the stock at the time of grant depends on the relevant facts and circumstances.[57] With respect to stock rights granted on or after January 1, 2005 and prior to the effective date of final regulations, however, the valuation requirements of Notice 2005-1, Q&A-4(d)(ii) remains in effect, although taxpayers may also rely on the Proposed 409A Regulations during this period.[58]

(e) Modifications, Extensions and Renewals of Stock Rights. Notice 2005-1 provides little guidance regarding the effect of a modification, extension or renewal of a stock option but implied that a modification, extension or renewal of an option would be treated as a new option except in the context of certain substitutions in connection with a corporate transaction. Notice 2005-1 provides that the substitution of a new option for an outstanding option in connection with a corporate transaction will not be treated as the grant of a new option if the requirements of Treasury Regulation Section 1.424-1 (relating to the substitution of a new incentive stock option for an outstanding incentive stock option in the context of a corporate transaction) would be satisfied if the stock option was an incentive stock option. In general, this requirement will be met if the ratio of the exercise price to the fair market value of the stock subject to the option after the substitution is not greater than the ratio of the exercise price to the fair market value of the stock subject to the option immediately prior to the substitution.[59] The Proposed 409A Regulations generally follow Notice 2005-1 on this issue but also provide

56 Id. at § II.B.

57 Id. at § II.A and Treas. Reg. § 1.422-2(e)(2).

58 Id. at § III

59 Notice 2005-1, Q&A-4(ii). Notice 2005-1 did not directly address the impact of a modification, extension or renewal of an SAR in the context of a corporate transaction or the impact of a modification, extension or renewal of a stock option or an SAR in contexts other than a corporate transaction.

substantial additional guidance concerning the impact of modifications, extensions and renewals of stock rights.[60]

In general, a modification (other than an extension or renewal) of the terms of a stock right will be treated as a grant of a new stock right which may or may not constitute a deferral of compensation depending on whether the terms of the new stock right satisfy the conditions for exemption from the requirements of Code Section 409A determined as of the grant date of the new stock right.[61] For purposes of Code Section 409A, a modification means a change in the terms of the stock right that provides the holder of the stock right with a direct or indirect reduction in the exercise price or an additional deferral feature, regardless of whether the option holder actually benefits from the change. In addition, any change in the terms of the stock subject to a stock right that increases its value is considered a modification to the stock right, except in the case of a substitution in the context of a corporate transaction.[62] If not revised by the final regulations, this provision may present a trap for the unwary if a corporate restructuring with no compensatory purpose causes an increase in the value of the stock subject to a stock right.

The Proposed 409A Regulations also clarify that certain actions are not considered modifications. These include (i) a reduction in the period during which the stock right may be exercised, (ii) adding a right to a stock option to tender previously acquired stock to pay the exercise price, and (iii) adding a share withholding feature to facilitate the payment of withholding and employment taxes.[63] The Proposed 409A Regulations also provide that the exercise of a right specifically reserved to the grantor with respect to transferability of a stock right will not be treated as an modification of the stock right.[64] It is not clear from the face of the regulation, however, whether the modification of stock right to add a transferability provision (rather than the exercise of a right specifically reserved to the grantor) would constitute a modification. Acceleration of the date on which a stock right may be exercised will not be treated as a modification that would cause a stock right that is not otherwise treated as deferred compensation to become deferred compensation. However, if the stock right is treated as deferred compensation under the Proposed 409A Regulations, the acceleration of the exercise date may constitute an impermissible acceleration of distribution under Code Section 409A.[65]

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60 Prop. Treas. Reg. § 1.409A-1(b)(5)(v)(D). The Proposed 409A Regulations also provide that in the case of corporate spinoff under Code Section 355, the conversion ratio may be determined using a stock price on a predetermined date that is not more than 60 days after the spinoff occurs. Id.

61 Prop. Treas. Reg. § 1.409A-1(b)(5)(v)(A).

62 Prop. Treas. Reg. § 1.409A-1(b)(5)(v)(G).

63 Prop. Treas. Reg. § 1.409A-1(b)(5)(v)(B).

64 Id.

65 Prop. Treas. Reg. § 1.409A-1(b)(5)(v)(E).

An extension or renewal of a stock right will generally be treated as adding an additional deferral feature to the outstanding grant and thereby cause the stock right to be treated as deferred compensation subject to the requirements of Code Section 409A from the original grant date.[66] Note that the Proposed 409A Regulations provide that an extension of the period for exercising a stock right will not be treated as an extension or renewal of the stock right if the period during which the stock right may be exercised is extended to a date that is no later than the later of the 15th day of the third calendar month following the date the stock right would otherwise expire or December 31 of the year in which the stock right would otherwise expire. In addition, the Proposed 409A Regulations provide that the period during which a stock right may be exercised will not be treated as an extension or modification if the expiration date is tolled while the stock right remains unexercisable because the exercise would violate applicable securities laws. In this case, the exercise period may be extended to a date that is not more than 30 days after the exercise of the stock right would no longer violate applicable securities laws.[67]

(f) Tandem Rights. Notice 2005-1 provides that if a stock option grants an option holder any rights in addition to the right to purchase stock at a fixed exercise price and such additional rights allow for the deferral of compensation (such as an option granted in tandem with SARs), the entire arrangement will be treated as deferred compensation.[68] This limitation was not included in the Proposed 409A Regulations apparently because options and SARs are subject to substantially identical treatment under the Proposed 409A Regulations.

(g) Rescission of Modifications, Extensions and Renewals. In the event that a stock right is modified, extended or renewed in a manner that causes it to be treated as nonqualified deferred compensation, the Proposed 409A Regulations provide that the change in the terms of the stock right will not be treated as a modification, extension or renewal if the change is rescinded on or before the earlier of the date the stock right is exercised or the last day of the calendar year in which the change in the terms of the stock right occurred.[69] This will give service recipients and service providers a limited period of time to correct changes to the terms of stock rights that would inadvertently affect the status and taxation of the stock right under Code Section 409A.

4. Separation Pay

Severance benefits (whether offered under a broad-based severance plan or pursuant to the terms of an employment agreement) may be treated as deferred compensation depending on

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66 Id.

67 Prop. Treas. Reg. § 1.409A-1(b)(5)(v)(C).

68 Notice 2005-1, Q&A-4(d)(ii).

69 Prop. Treas. Reg. § 1.409A-1(b)(5)(v)(I).

the terms of the arrangement. However, the Proposed 409A Regulations provide broad relief exempting separation pay plans that meet certain conditions from the requirements of Code Section 409A. Under this relief, separation pay will not be treated as deferred compensation if the separation pay meets any of the following exemptions:

(i) The separation pay is paid pursuant to plan established pursuant to collective bargaining and is paid on account of an employee's actual involuntary termination of employment or pursuant to a window program.[70]

(ii) The separation pay is paid from a separation pay plan on account of an employee's actual involuntary termination of employment or pursuant to a window program if the plan:

(x) limits the amount of the separation pay to two times the lesser of the employee's annual compensation for services provided to the service recipient during the calendar year preceding the year in which the service provider has a separation from service or the maximum amount of compensation that may be taken into account under a qualified retirement plan under Code Section 401(a)(17) ($220,000 for 2006), and

(y) the separation pay must be paid no later than December 31 of the second calendar year in which the service provider separates from service.[71]

(iii) The plan provides for payment for a limited period of time (no later than December 31 of the second year following the year in which the separation from service occurs) of reimbursements that that are otherwise excludable from gross income of expenses that are deductible by the service provider as business expenses, reasonable outplacement services, moving expenses, and reimbursement of certain medical expenses.[72]

A window program is a program implemented by a service recipient for a limited period of time (not greater than one year) to provide separation pay to service providers who separate from service during the specified period of time under specified circumstances. A program will not be considered a window program if the service recipient established a pattern of repeatedly

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70 Prop. Treas. Reg. § 1.409A-1(b)(9)(ii).

71 Prop. Treas. Reg. § 1.409A-1(b)(9)(iii).

72 Prop. Treas. Reg. § 1.409A-1(b)(9)(iv).

establishing programs providing similar separation pay in similar situations for substantially consecutive limited periods.[73]

Note that even if severance pay does not meet any of the foregoing exemptions (for example if the amount of the severance pay exceeds $440,000 in 2006, i.e., twice the Code Section 401(a)(17) limit), the severance pay may be treated as a payment that is not deferred compensation if the entire amount of the severance pay is payable only on account of an involuntary separation from service and is paid within 2½ months after the end of the taxable year in which the service provider has a separation from service. If, however, severance benefits are paid in the form of salary continuation extending more than 2½ months after the end of the year in which the separation from service occurs or if the payment is made on account of a voluntary termination (including termination for good reason), the severance benefits would be treated as deferred compensation for purposes of the Proposed 409A Regulations.

Severance pay that is treated as deferred compensation may also be structured to meet all of the requirements of Code Section 409A. In general, this requires the severance pay arrangement to specify a fixed payment schedule that is not subject to the service provider's election. In addition, in the case of a key employee of a publicly traded service recipient, the distribution of the severance pay arrangement must provide that the severance payments will not commence until six months after separation from service.

5. Payments to Partners of a Partnership

Notice 2005-1 provides that Code Section 409A may apply to certain compensation arrangements between a partner and a partnership. Notice 2005-1 expressly provides that payments made pursuant to an arrangement between a partnership and retired partner that qualify as payments to a partner under Code Section 1402(a)(10) will be treated as deferred compensation for purposes of Code Section 409A.[74] However, until further guidance is issued, the grant of a profits interest in connection with the performance of services will not be treated as deferred compensation.[75] These two provisions may be difficult to reconcile. Partnership retirement arrangements often provide for payment for a specified period of years in an amount that is determined based on the partnership's income and then a smaller fixed payment for the duration of the remainder of the retired partner's life. To the extent that the payments are determined based on partnership income, the payments are treated as a distribution of the

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73 Prop. Treas. Reg. § 1.409A-1(b)(9)(v).

74 Notice 2005-1, Q&A-7. Payments made by a partnership to a partner during a taxable year will qualify under Code Section 1402(a)(10) if (i) the payments are made pursuant to a written agreement providing for periodic payments to the retired partner until the retired partner's death, (ii) the partner does not render any services to the partnership during the taxable year, (iii) the partnership has no obligation to the retired partner as of the close of its taxable year other than the retirement payments, and (iv) the retired partner's capital interest in the partnership has been fully distributed before the close of the taxable year.

75 Notice 2005-1, Q&A-7.

partner's distributive share (i.e., a profits interest).[76] Thus, the payments to the retired partner may simultaneously qualify as a profits interest (which is not treated as deferred compensation) and as retirement payments described in Code Section 1402(a)(10) (which would be treated as deferred compensation).

The Proposed 409A Regulations do not provide any guidance on payments to partners. Accordingly, pending the issuance of additional guidance, partnerships will need to comply with the guidance issued under Notice 2005-1 with respect to payments to partners.

6. Foreign Compensation Arrangements

The Proposed 409A Regulations provide a number of exemptions from the definition of deferred compensation for foreign deferred compensation arrangements and arrangements involving nonresident aliens.

The deferral of compensation will not be subject to Code Section 409A to the extent that the compensation being deferred would have been excluded from the service provider's gross income had the compensation been paid to the service provider when the service provider obtains a legally binding right to the compensation or, if later, at the time the compensation vests (i) due to tax treaties or similar international tax convention or agreement,[77] or (ii) because the service provider was a nonresident alien, a qualified individual within the meaning of Code Section 911(d)(1) (i.e., a U.S. citizen who resides in a foreign country or a U.S. citizen or resident who is present in a foreign country or countries for at least 330 full days during a twelve consecutive month period), or a resident of certain U.S. territories whose residents are not subject to U.S. Federal income tax.[78]

Compensation paid under a tax equalization arrangement is not considered deferred compensation if the payments made under the arrangement are paid no later than the end of the second year beginning after the calendar year in which the service provider's U.S. Federal income tax return is due (including extensions) for the year to which the tax equalization payment relates. A tax equalization arrangement is an arrangement that provides payments to the service provider intended to compensate a service provider for the excess of the foreign taxes actually imposed on the compensation paid to the service provider over the amount of taxes that would have been imposed had the compensation been taxable only in the United States.[79]

Compensation deferred on behalf of a nonresident alien and certain resident aliens under broad-based foreign retirement plans are not subject to Code Section 409A. In addition, participation by a U.S. citizen or resident alien in a broad-based foreign retirement plan will not

[76] Code § 736(a)(1).

[77] Prop. Treas. Reg. § 1.409A-1(b)(8)(i).

[78] Prop. Treas. Reg. § 1.409A-1(b)(8)(ii).

[79] Prop. Treas. Reg. § 1.409A-1(b)(8)(iii).

be treated as deferred compensation if he or she is not eligible to participate in a U.S. qualified retirement plan; provided that this exclusion applies only to the extent that the amounts deferred under the foreign plan does not exceed the applicable benefit or contribution limits imposed under Code Section 415(b) or (c). Contributions made under certain foreign social security systems are also not subject to Code Section 409A.[80]

7. Exempt Arrangements

Code Section 409A expressly exempts the following arrangements from the requirements of Code Section 409A:

(i) retirement plans qualified under Code Section 401(a) or 403(a),

(ii) tax deferred annuities described in Code Section 403(b),

(iii) simplified employee pensions described in Code Section 408(k),

(iv) simple retirement accounts described in Code Section 408(p),

(v) eligible deferred compensation arrangements described in Section 457(b),

(vi) qualified governmental excess benefit arrangements described in Code Section 415(m),

(vii) bona fide vacation leave, sick leave, compensatory time, disability pay and death benefit plans, and

(viii) Archer medical savings accounts described in Code Section 220, health savings accounts described in Code Section 223 or any other medical reimbursement account.[81]

D. Service Providers to Whom Code Section 409A Applies

Code Section 409A is not limited to deferred compensation arrangements between employers and employees. Thus, Code Section 409A may apply to service providers who are independent contractors, partners of a partnership and corporate directors, without regard to whether such service providers are individuals, corporations, partnerships or other entities.[82]

Code Section 409A does not apply to all service providers, however. Notice 2005-1 provides that, until additional guidance is issued, Code Section 409A will apply to any service

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[80] Prop. Treas. Reg. § 1.409A-1(a)(3).

[81] Code § 409A(d)(1) and (2).

[82] Notice 2005-1, Q&A-3(a); Prop. Treas. Reg. § 1.409A-1(f)(1).

provider that is (i) an individual, (ii) a personal service corporation (as defined in Code Section 269A(b)(1))[83] or a noncorporate entity that would be a personal service corporation if it were a corporation, or (iii) a qualified personal service corporation (as defined in Code Section 448(d)(2))[84] or a noncorporate entity that would be a qualified service corporation if it were a corporation.[85] The Proposed 409A Regulations, however, do not include these limitations on which entities may be treated as service providers. Thus, under the Proposed 409A Regulations, a corporation that is not a personal service corporation or a qualified personal service corporation may be treated as a service provider unless another exemption applies. Until the Proposed 409A Regulations are finalized, however, taxpayers may continue to rely on Notice 2005-1.

Code Section 409A does not apply to any deferral arrangement if the service provider is an accrual basis taxpayer in the year in which the service provider obtains a legally binding right to the deferred compensation.[86]

Notice 2005-1 and the Proposed 409A Regulations also provide that Code Section 409A does not apply to an arrangement between a service provider and service recipient if: (i) the service provider is actively engaged in the trade or business of providing substantial services (other than as an employee or as a director of a corporation), and (ii) the service provider provides such substantial services to two or more unrelated service recipients and (iii) the service provider is unrelated to the service recipients.[87] For purposes of this exemption, a person will be treated as related to another person (i) pursuant to Code Section 267(b) or 707(b)(1), with certain modifications, or (ii) the persons are engaged in trades or businesses under common control within the meaning of Code Section 52(a) or (b). Code Sections 267(b), 707(b)(1) and 52 set forth "related party relationships" between individuals and family members, individuals and corporations, among corporations, individuals and partnerships and partnership and corporations. The Proposed 409A Regulations also clarify that a service provider will be treated as related to the service recipient if the service provider performs management services to the service recipient.[88]

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83 A personal service corporation under Code Section 269A is generally a corporation the principle activity of which is the performance of personal services that are substantially performed by employees-owners. An employee-owner is an individual who owns, directly or indirectly, more than 10% of the outstanding stock. See Prop. Treas. Reg. § 1.269A-1(b).

84 A qualified personal service corporation under Code Section 448(d)(2) is a corporation (i) substantially all activities of which involve the performance of services and (ii) 95% or more of the stock of which is held, directly or indirectly by individuals who are employees performing services for the corporation. See Temp. Treas. Reg. § 1.448-1T(e)(3), (4), (5).

85 Notice 2005-1, Q&A-8.

86 Notice 2005-1, Q&A-8; Prop. Treas. Reg. § 1.409A-1(f)(2).

87 Id.; Prop. Treas. Reg. § 1.409A-1(f)(3)(i).

88 Prop. Treas. Reg. § 1.409A-1(f)(3)(iv).

Whether a service provider provides significant services to two or more unrelated service recipients depends on the facts and circumstances. However, a service provider will be deemed to provide significant services to two or more unrelated service recipients for a taxable year if the revenues generated from the provision of such services during the taxable year to a single service recipient (or group of related service recipients) do not exceed 70 percent of the service provider's total revenues from the provision of such services during the taxable year.[89]

E. Distribution Restrictions

Code Section 409A substantially reduces the flexibility of service providers and service recipients in determining when deferred compensation may be paid. A deferred compensation plan will not satisfy the distribution restrictions imposed under Code Section 409A(a)(2) unless the plan provides that distributions will not be made earlier than:

(i) separation from service,

(ii) the date the service provider becomes disabled,

(iii) the service provider's death,

(iv) a specified time (or pursuant to a fixed schedule) specified under the plan at the date of the deferral of the compensation,

(v) upon a change of control event, or

(vi) the occurrence of an unforeseeable emergency.

Code § 409A(a)(2)(A).

A payment will be treated as being payable upon the occurrence of a specified event if the arrangement provides for payment on a payment date that is objectively determinable on the date the event occurs (e.g., January 1 following death or 5th anniversary following separation from service). In addition, an arrangement may provide for a payment to be made in a specified year (e.g., payment in the year following separation from service), in which case the payment date will be deemed to be January 1 of such payment year.[90]

An arrangement may also provide for a different payment schedule for different payment events if the payment schedule is objectively determinable upon the occurrence of the event.[91] For example, a plan may provide that payment will be made in the form of installments

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89 Prop. Treas. Reg. § 1.409A-1(f)(3)(iii).

90 Prop. Treas. Reg. § 1.409A-3(b).

91 Id.

commencing at separation from service or in a lump sum at death. Likewise, a plan may provide for a lump sum distribution if the present value of the benefit at the time of the event does not exceed a specified dollar amount and installments if the present value of the exceeds such specified dollar amount.

Section 409A imposes several special rules applicable to the distribution events listed above. These special rules, which generally narrow the scope or definition of the event or impose additional restrictions applicable to the event, are described below.

1. Time Payment is Made

A payment will be treated as made on the specified payment date (including a payment date that is specified in relation to a payment event such as January 1 following separation from service), if the payment is made on the specified payment date or any later date within the same calendar year that the payment is due, or if later, by the 15th day of the third month after the date the payment is due.[92]

The Proposed 409A Regulations clarify certain circumstances under which a payment that is not timely made will be treated as if it was timely paid for purposes of Code Section 409A. If a service recipient refuses to make a payment that is due under an arrangement, the payment will be treated as timely paid if (i) the service provider accepts payment of the portion of the payment the service recipient is willing to pay (unless such acceptance would result in a forfeiture of the service provider's claim to the remaining amount due), (ii) the service provider makes prompt and reasonable, good-faith effort to collect the amount due, and (iii) and the amount is paid in the first calendar year in which the service recipient and service provider enter into a legally binding settlement of the dispute, the service recipient concedes that the amount is payable or the service recipient is required to make such payment pursuant to a final nonappealable judgment or other binding decision.[93] Note that this exception does not apply if the decision not to pay the deferred compensation when due is made on behalf of the service recipient by the service provider or a member of the service provider's family.[94]

2. Separation from Service

Code Section 409A(d)(6) clarifies that controlled group rules similar to those under Code Section 414(b) and (c) will apply for purposes of Code Section 409A. Thus, for instance, an employee whose employment is transferred from one company to another within the same controlled group would not be treated as having a separation from service.

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[92] Prop. Treas. Reg. § 1.409A-3(d).

[93] Prop. Treas. Reg. § 1.409A-3(e).

[94] Id.

The Proposed 409A Regulations provide different definitions of separation from service for employees and independent contractors. An employee will have a separation from service with the service recipient if the employee's employment relationship with the employer terminates. The employment relationship, however, will be treated as ongoing if the employee is on military leave, sick leave or other bona fide leave of absence that does not exceed six months or, if longer, the period during which the individual has reemployment rights by contract or statute.[95]

Whether a termination of employment has occurred depends on the facts and circumstances, including whether the employer and individual intend the individual to continue performing substantial services. The Proposed 409A Regulations provide that an employer and employee will not be treated as having intended the employee to provide insignificant services where the employee continues to provide services as an employee at an annual rate that is at least equal to 20 percent of services rendered, on average, during the immediately preceding three years. If an employee continues to provide services in a capacity other than as an employee, a separation from service will not be deemed to have occurred if the former employee is provided services at an annual rate that is 50 percent or more of the services rendered, on average, during the immediately preceding three years.[96]

An independent contractor will be treated as having had a separation from service with the service recipient upon the expiration of the contract (or if there is more than one contract, upon expiration of all contracts) with the service recipient if the expiration of the contract constitutes a good-faith and complete termination of the contractual relationship. A good-faith and complete termination of the contractual relationship will not be treated as having occurred if the service recipient anticipates the renewal of the independent contractor relationship or the independent contractor becoming an employee.[97]

The Proposed 409A Regulations provide a payment will be deemed to have been paid on account of a separation from service if the arrangement provides that no amount will be paid until 12 months and one day after the contract between the service recipient and the independent contractor expires and no amount will be paid if after the expiration of the contract and before the payment date, the service provider performs services for the service recipient as an independent contractor or employee.[98]

3. Key Employees of Publicly Traded Companies

If a nonqualified deferred compensation plan is maintained by a corporation whose stock is publicly traded on an established securities market or otherwise, the plan may not allow the

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95 Prop. Treas. Reg. § 1.409A-1(h)(1).

96 Prop. Treas. Reg. § 1.409A-1(h)(1)(ii).

97 Prop. Treas. Reg. § 1.409A-1(h)(2).

98 Id.

payment of nonqualified deferred compensation to any key employee (as defined in Section 416(i) of the Code) on account of separation from service until six months after such key employee's termination of service.[99]

Section 416(i) provides that an employee will be considered a "key employee" for a plan year if, at any time during the plan year, the employee is (i) an officer earning more than $130,000 per year (adjusted for cost of living increases),[100] (ii) a 5% shareholder of the employer, and (iii) a 1% shareholder of the employer earning more than $150,000.[101] The definition of key employee for purposes of Code Section 409A does not include the beneficiary of a deceased employee.[102] The Proposed 409A Regulations provide a helpful look back rule for the determination of key employees for purposes of this restriction. Under this look back rule, the service recipient may specify an identification date within the calendar year. If an employee meets the requirements of (i), (ii) or (iii) above at any time during the 12 month period ending on the identification date, the employee will be designated as a key employee for purposes of Code Section 409A for the 12 month period commencing on the first day of the fourth month following the identification date.[103] For instance, if the employer specifies September 30 as the identification date, an employee who meets the key employee requirements at any time during the period from October 1, 2006 through September 30, 2007 will be treated as a key employee for purposes of Code Section 409A for calendar year 2008.

The service recipient must use the same identification date for all deferred compensation arrangements maintained by the service recipient. The service recipient may change the identification date but the change in the identification dates may not become effective for a period of 12 months. If the service recipient does not designate an identification date, the identification date will be deemed to be December 31.[104]

Note that this restriction on distributions to key employees does not apply to distributions on account of death, disability, change of control, or unforeseeable emergency or at a specified time (or pursuant to a fixed schedule) specified under the plan at the date of the deferral.

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99 Code § 409A(a)(2)(B)(i).

100 No more than 50 officers (or if less, the greater of 3 or 10% of the employer's employees) will be treated as officers. Only the highest paid officers will be treated as officers under this rule. Code § 416(i)(1)(A).

101 Code § 416(i)(1).

102 Code § 409A(a)(2)(B)(i).

103 Prop. Treas. Reg. § 1.409A-1(i)(1).

104 <u>Id.</u>

4. Disability

A participant in a nonqualified deferred compensation plan will not be considered disabled for purposes of the distribution restrictions under Code Section 409A(a)(2)(A) unless the participant, due to a medically determinable physical or mental impairment that is expected to result in death or last at least 12 consecutive months, (i) is unable to engage in any substantial gainful activity or (ii) is receiving income replacement benefits for a period of not less than 3 months under an accident and health plan covering employees of the participant's employer.[105]

5. Specified Time or Pursuant to a Fixed Schedule

The AJCA Conference Report clarifies that the specified time of distribution(s) of nonqualified deferred compensation or fixed payment schedule for payment of such must be specified under the plan at the time of the deferral. In addition, the Conference Report states that distributions payable on the occurrence of an event will not satisfy this requirement.[106] For instance, a payment made on account of a participant's child entering college will be considered a payment upon the occurrence of an event that does not satisfy the distribution restrictions. On the other hand, a payment of nonqualified deferred compensation when a participant attains age 65 will be considered a payment at a specified time.

The Proposed 409A Regulations provide that a payment will be treated as payable at a specified time or upon a fixed schedule if objectively determinable amounts are payable at a date or dates that are objectively determinable at the time the amount is deferred. An amount is objectively determinable if the amount is determined pursuant to a nondiscretionary formula (including a specified percentage of the participant's account balance). A payment made pursuant to a fixed schedule upon a vesting event; provided that any acceleration of vesting must be disregarded unless the acceleration of vesting is due to the occurrence of a vesting event specified at the time the service provider obtains a legally binding right to the payment.[107] For example, if a long-term bonus vests upon continuous employment through December 31, 2008 or, if earlier, the occurrence of an initial public offering of the service recipient, an arrangement may specify that a long-term bonus will be distributed in three equal annual installments commencing with the year following the year in which the bonus vests. Under this arrangement distribution of the long-term bonus must commence in 2009 or, if earlier, the year following the occurrence of an initial public offering. However, the distribution may not be accelerated due to an amendment to the terms of the long-term bonus to accelerate the vesting of the long-term bonus.

Note, however, that these distribution restrictions apply only to deferred compensation. For instance, if, a bonus is payable in full no later than 2½ months after the end of the year in

105 Code § 409A(a)(2)(C); Prop. Treas. Reg. § 1.409-3(g)(4).

106 H.R. Conf. Rep. 108-755 at 716.

107 Prop. Treas. Reg. § 1.409A-3(g)(1).

which the bonus vests, the payment of the bonus upon vesting should not be treated as deferred compensation for purposes of Code Section 409A, even if the vesting of the bonus is accelerated.

6. Change of Control Event

Distributions upon a change of control are permitted to the extent permitted by the Secretary of the Treasury. Notice 2005-1 and the Proposed 409A Regulations provide that a plan may permit a payment upon the occurrence of a change of control event. A change of control event is a change in ownership of the corporation, change in effective control of the corporation or a change in ownership of a substantial portion of the assets of the corporation.[108]

Note that the change of control events apply only to corporations. Payouts are not permitted based on the change of control of a partnership, association or any other non-corporate entity.[109]

In addition, a change of control event with respect to a service provider must relate to (i) the corporation for whom the service provider is performing services at the time of the change of control event, (ii) the corporation that is liable for the payment (or all corporations that are liable for the payment if more than one corporation is liable), (iii) a corporation that is a majority shareholder of the corporation identified in (i) or (ii) or any corporation in a chain of corporations in which each such corporation is a majority shareholder of another shareholder in the chain ending with a corporation identified in (i) or (ii).[110] Thus, for instance, suppose corporation S2 is wholly owned by corporation S1 which is wholly owned by parent company (P). If P sells its entire interest in S1, the sale will be treated as a change of control event with respect to service providers who provide services to S1 and service providers who provide services to S2. However, P's sale of S1 will not be treated as a change of control event with respect to service providers who are providing services to P unless the sale of S1 constitutes a change of ownership of a substantial portion of the assets of P.

If a plan provides for payment upon a change of control event, the occurrence of a change of control event must be objectively determinable and any requirement that a person (such as the board of directors, the plan administrator or any other person) certify that a change of control event has occurred must be purely ministerial. Notice 2005-1 provides that a payment may also be treated as occurring upon a change of control event, if the right to the payment arises due to the corporation's exercise of discretion under the terms of the plan to terminate the plan and distribute the deferred compensation within 12 months after the change of control.[111] The Proposed 409A Regulations also allow a service recipient to exercise discretion to terminate the plan following a change of control event, but only if the service recipient terminates all

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[108] Notice 2005-1, Q&A-11(a); Prop. Treas. Reg. § 1.409A-3(g)(5)(i).

[109] Id.

[110] Notice 2005-1, Q&A-11(b); Prop. Treas. Reg. § 1.409A-3(g)(5)(ii)(A).

[111] Id.

substantially similar arrangements so that all participants under substantially similar arrangements are required to receive the payment within 12 months following the occurrence of a change of control event.[112]

For purposes of determining stock ownership for purposes of determining whether a change of control event has occurred, the attribution rules under Code Section 318(a) apply. In addition, shares of stock underlying stock options are treated as owned by the option holder. If, however, an option is exercisable only for restricted stock, the stock underlying the option will not be treated as held by the option holder.[113]

(a) Change in Ownership of a Corporation. A change in ownership of a corporation will occur when one or more persons acting as a group acquire ownership of stock of the corporation that together with any stock previously held by such person or group constitutes more than 50% of the fair market value of the corporation or more than 50% of the voting power of all stock of the corporation. If the persons acting as a group have more than 50% of the fair market value of all stock or more than 50% of the voting power of all stock of the corporation, the acquisition of additional stock by any member of the group will not result in a change of ownership.[114]

(b) Change in Effective Control of a Corporation. A change in effective control of a corporation will occur when (i) one or more persons acting as a group acquires (or has acquired within a 12 month period) ownership of stock of the corporation possessing 35% or more of the total voting power of the stock of the corporation or (ii) a majority of the members of the corporation's board of directors is replaced during a 12 month period by directors whose appointment or election is not endorsed by a majority of the corporation's board of directors immediately prior to such appointment or election. A change of effective ownership of a corporation based on the appointment of a majority of its board of directors will occur only if there is no other corporation that is a majority shareholder of such corporation.[115]

If one or more persons acting as a group already effectively controls a corporation based on the effective control standards described above, the acquisition of additional shares of stock by any member of such group will not result in a change in effective control of the corporation.[116]

(c) Change in Ownership of a Substantial Portion of the Corporation's Assets. A change in ownership of a substantial portion of a corporation's assets will

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112 Prop. Treas. Reg. § 1.409A-3(h)(viii)(B).

113 Notice 2005-1, Q&A-11(c); Prop. Treas. Reg. § 1.409A-3(g)(5)(iii).

114 Notice 2005-1, Q&A-12(a); Prop. Treas. Reg. § 1.409A-3(g)(5)(v).

115 Notice 2005-1, Q&A-13(a); Prop. Treas. Reg. § 1.409A-3(g)(vi).

116 Notice 2005-1, Q&A-13(c); Prop. Treas. Reg. § 1.409A-3(g)(vi)(C).

occur when (i) one or more persons acting as a group acquires (or has acquired within a 12 month period) assets from the corporation that have a total gross fair market value equal to more than 40% of the total gross fair market value of all assets of the corporation immediately prior to the acquisition. Total gross fair market value is determined without regard to any liabilities associated with the acquired assets.[117] The transfer of assets to certain persons or entities that are related to the corporation or its shareholders does not qualify as a change of control.[118]

7. Unforeseeable Emergency

Unforeseeable emergency is defined as a severe financial hardship resulting from an illness or accident of the participant or the participant's spouse or dependents, loss of property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant.[119] The amount that may be distributed as a result of an unforeseeable emergency may not exceed the amount necessary to satisfy the emergency (to the extent that the emergency cannot be relieved through reimbursement by insurance or by liquidation of assets that would not in itself result in a severe financial hardship) plus taxes reasonably anticipated as a result of the distribution.[120]

F. Prohibition on Acceleration of Distributions

Except to the extent permitted in Treasury guidance, a nonqualified deferred compensation plan may not permit the acceleration of the time of any payment under the plan.[121]

Notice 2005-1 and the Proposed 409A Regulations provide several exceptions to the prohibition on accelerations.

1. Acceleration of Vesting

A nonqualified deferred compensation plan does not violate the prohibition on acceleration of distributions if the service recipient accelerates the vesting (or waives a vesting condition) with respect to the deferred compensation as long as the requirements of Code Section 409A are met.[122]

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117 Notice 2005-1, Q&A-14(a); Prop. Treas. Reg. § 1.409A-3(g)(vii).

118 Notice 2005-1, Q&A-14(b); Prop. Treas. Reg. § 1.409A-3(g)(vii)(B).

119 Code § 409A(a)(2)(B)(ii)(I).

120 Code § 409A(a)(2)(B)(ii)(II).

121 Code § 409A(a)(3).

122 Notice 2005-1, Q&A-15(a); Prop. Treas. Reg. § 1.409A-3(h)(1).

2. Domestic Relations Orders

A plan may permit the acceleration of the payment of deferred compensation to a person other than the service provider to the extent necessary to comply with a domestic relations order.[123]

3. Conflict of Interest

A plan may permit the acceleration of the payment of deferred compensation to the extent necessary to comply with a "certificate of divesture."[124] A certificate of divestiture is a written determination issued by the President or the Director of the Office of Government Ethics stating that certain divestiture of specific property is required to comply with Federal conflict of interest laws or as requested by a congressional committee as a condition to confirmation.[125]

4. Payment of Taxes Due Upon Vesting Under a 457(f) Plan

If a plan is subject to Code Section 457(f), the plan may provide for the acceleration of distribution of amounts needed to pay income taxes that are due upon a vesting event. The amount of the accelerated payment may not exceed the amount of tax withholding that the employer would have remitted if the employer had paid the service provider wages in an amount equal to the amount included in the service provider's income under Code Section 457(f) as of the date the deferred compensation vests.[126]

5. De Minimis Distributions

A plan that does not otherwise provide a de minimis cashout provision may be amended to accelerate the distributions to a participant if (i) the payment results in the termination of the participant's entire interest in the plan, (ii) the payment is made on or before the later of December 31 of the calendar year in which the participant has a separation from service or the 15th day of the third month following the participant's separation from service, (iii) the distribution does not exceed $10,000 and (iv) the participant is not provided with an election with respect to the receipt of the lump sum payment.[127] Note that for purposes of this rule, the provision requiring all plans of the same type (i.e., account balance plans, nonaccount balance plans and all other plans) be treated as a single plan does not apply.[128] Thus, if a person participates in two account balance arrangements, the de minimis cashout provisions may be added to each such arrangement independently.

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[123] Notice 2005-1, Q&A-15(b); Prop. Treas. Reg. § 1.409A-3(h)(2)(i).

[124] Notice 2005-1, Q&A-15(c); Prop. Treas. Reg. § 1.409A-3(h)(2)(ii).

[125] Code § 1043(b)(2); Prop. Treas. Reg. § 1.409A-3(h)(2)(iii).

[126] Notice 2005-1, Q&A-15(d); Prop. Treas. Reg. § 1.409A-3(h)(2)(iii).

[127] Notice 2005-1, Q&A-15(e); Prop. Treas. Reg. § 1.409A-3(h)(2)(iv).

[128] Notice 2005-1, Q&A-15(g); Prop. Treas. Reg. § 1.409A-3(h)(2)(iv)(A)(1).

6. Payment of Employment Taxes

A plan may permit acceleration of payments under a deferred compensation plan to pay FICA taxes due under Code Section 3121(v)(2) with respect to the amounts deferred under the plan. In addition, the amount distributed may also include an amount necessary to pay any income tax withholding due with respect to the amounts distributed.[129]

7. Payment Upon Income Inclusion Under Code Section 409A

An arrangement may permit the acceleration of payments to a service provider under the plan at the time the arrangement fails to meet the requirements of Code Section 409A. The amount of the accelerated payment may not exceed the amount required to be included in the service provider's income with respect to such failure.[130]

8. Plan Terminations

The Proposed 409A Regulations permit a service recipient to terminate a deferred compensation plan and accelerate the distribution of the amounts deferred under certain limited circumstances.

(a) Corporate Dissolution or Bankruptcy. A service recipient may, in its discretion, terminate a deferred compensation arrangement within 12 months of a corporate dissolution taxable under Code Section 331 or with the approval of the bankruptcy court pursuant to Section 503(b)(1)(A) of the Bankruptcy Code if the amounts are distributed no later than (i) the calendar year in which the plan is terminated, (ii) the calendar year in which the payment vests, or (iii) the first calendar year in which the payment is administratively practicable.[131]

(b) Termination Following a Change of Control Event. A service recipient may, in its discretion, terminate a deferred compensation arrangement within the 30 days before or 12 months after the occurrence of a change of control event, if all substantially similar arrangements sponsored by the service recipient are terminated so that all participants in all similar arrangements are required to receive a distribution of the amounts deferred under such arrangements within 12 months after the date of termination of such arrangements.[132]

(c) Other Plan Terminations. A service recipient may, in its discretion, terminate a deferred compensation arrangement if: (i) the service recipient

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129 Notice 2005-1, Q&A-15(f); Prop. Treas. Reg. § 1.409A-3(h)(2)(v).

130 Prop. Treas. Reg. § 1.409A-3(h)(2)(vi).

131 Prop. Treas. Reg. § 1.409A-3(h)(2)(viii)(A).

132 Prop. Treas. Reg. § 1.409A-3(h)(2)(viii)(B).

terminates all substantially similar arrangements sponsored by the service recipient, (ii) no payment is made on account of the termination (other than payments that would have been payable in the absence of the plan termination) are paid within 12 months after termination of the arrangements; (iii) all payments are made within 24 months of the termination, and (iv) the service recipient does not establish any new deferred compensation arrangements of a similar type at any time within five years after the plan termination.[133]

(d) Certain Payments to Avoid Nonallocation Year Under Code Section 409(p). An arrangement may permit the acceleration of a payment to prevent the occurrence of a nonallocation year under Code Section 409(p) (imposing certain restrictions on ESOPs established by an s-corporation).[134]

G. Deferral Elections

1. Initial Election

A nonqualified deferred compensation plan that permits participant deferral elections must provide that compensation for services performed during a taxable year may be deferred at the election of the participant only if the deferral election is made no later than the close of the preceding year or at such other time as provided by regulation.[135] Thus, for instance, if a participant's 2006 bonus is payable in March of 2007, an election to defer the bonus must be made before the end of 2005, more than 14 months prior to the payment of the bonus.

Code Section 409A and the Proposed 409A Regulations provide a few limited exceptions from this rule.

(a) Election With Respect to Performance-Based Compensation

A limited exception to this requirement applies in the case of "performance-based compensation." Under this exception, performance-based compensation, which is based on services performed over a period of at least 12 months may be made no later than 6 months prior to the end of the service period.[136] The Proposed 409A Regulations provide that compensation will be treated as performance-based if (i) the payment of or the amount of the compensation is contingent on satisfaction of organizational or individual performance goals, and (ii) the performance criteria are not substantially certain to be met at the time the deferral election is made.[137] The term performance-based compensation

[133] Prop. Treas. Reg. § 1.409A-3(h)(2)(viii)(C).

[134] Prop. Treas. Reg. § 1.409A-3(h)(2)(ix).

[135] Code § 409A(a)(4)(B)(i).

[136] Code § 409A(a)(4)(B)(iii).

[137] Notice 2005-1, Q&A-22; Prop. Treas. Reg. §§ 1.409A-1(e)(1) & -2(a)(7).

does not, however, include any amount that will be paid regardless of performance or if the performance criteria is substantially certain to be met at the time the performance criteria is established. In addition, except in limited circumstances, performance-based compensation does not include any amount that is based solely on the value of, or the appreciation in value of, the service recipient or the stock of the service recipient.[138]

The performance criteria may be subjective provided that (i) the subjective performance criteria must relate to the participant service provider, a group of service providers that includes the participant service provider or a business unit for which the participant service provider provides services (which may include the entire organization) and (ii) the determination that such subjective performance criteria has been met may not be made by the participant service provider or any member of the participant service provider's family.[139] There is no requirement that the performance criteria be approved by the service recipient's board of directors (or similar executive committee), compensation committee, shareholders or members.[140]

(b) Initial Election With Respect to Short-Term Deferrals. A service provider may make an initial deferral election with respect to any payment that, in the absence of a deferral election, would be exempt from Code Section 409A as a short term deferral if the election is made at least 12 months before the service provider obtains a legally binding right to the payment or the payment vests.[141]

(c) Initial Election With Unvested Compensation. A service provider may make an initial deferral election with respect to any unvested compensation that would not be treated as deferred compensation subject to Section 409A in the absence of a deferral election if the election is made on or before the date the 30th day after the service provider obtains a legally binding right to the payment; provided that the election is made at least 12 months before the earliest date on which the payment may vest.[142]

(d) First Year of Eligibility. A new participant may make an initial deferral election with respect to compensation for services performed after the election is made if the election is made within 30 days after the person first becomes eligible to participate in the plan.[143]

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138 Notice 2005-1, Q&A-22; Prop. Treas. Reg. § 1.409A-1(e)(1).

139 Notice 2005-1, Q&A-22; Prop. Treas. Reg. §§ 1.409A-1(e)(2).

140 Id.

141 Prop. Treas. Reg. § 1.409A-2(a)(3).

142 Prop. Treas. Reg. § 1.409A-2(a)(4).

143 Code § 409A(a)(4)(B)(ii); Prop. Treas. Reg. § 1.409A-2(a)(6).

2. Subsequent Elections to Change the Form and Timing of Distributions

A deferred compensation plan may permit a participant to make a subsequent election to delay the timing or change the form of payment of amounts previously deferred if:

(i) the election does not become effective until at least 12 months after the election is made;

(ii) the election is made at least 12 months before the first scheduled payment of the deferred compensation; and

(iii) except for payments made on account of death, disability or unforeseeable emergency, the election extends the deferral of the payment for a period of at least 5 years.[144]

The Proposed 409A Regulations provide that for purposes of applying this rule a single payment date exists with respect to each form of distribution. For instance, the payment date for payments in the form of an annuity or installments is the date the first payment under each form is scheduled to be paid.[145] Thus, under this rule, a participant may change from an annuity form of distribution to a lump sum payment if conditions above are met even though the lump sum payment would be made before all of the annuity payments would have been made.

The Proposed 409A Regulations also provide that if a plan permits payment upon a number of different payments events, the subsequent election rules are applied separately with respect to each distribution payment due upon each event. For example, if a plan provides for a lump sum payment commencing on the earlier of December 31, 2010 or separation from service, a participant may elect prior to December 31, 2009 to change the payment date from December 31, 2010 to December 31, 2015 without changing the payment upon separation from service.[146]

3. Certain Permissible Delays in Payments

The Proposed 409A Regulations also permit a plan to provide for a delays in payments under certain circumstances, such as where the payment would result in a loss of tax deduction to the service recipient under Code Section 162(m), or would result in the violation of a loan covenant or a similar contract to which the service recipient is a party or would violate Federal securities laws.[147]

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[144] Code § 409A(a)(4)(C).

[145] Prop. Treas. Reg. § 1.409A-2(b)(2).

[146] Prop. Treas. Reg. § 1.409A-2(b)(4).

[147] Prop. Treas. Reg. § 1.409A-2(b)(5).

H. Additional Restrictions on Funding

1. Transfer of Assets to Offshore Trusts

Code Section 409(b) provides that a transfer of property in connection with the performance of services for purposes of Section 83 will be deemed to occur if any assets are directly or indirectly set aside in a trust or similar arrangement located outside of the United States for purposes of paying benefits under a nonqualified deferred compensation plan. The transfer for purposes of Section 83 will be treated as occurring (i) at the time such assets are set aside in the trust or similar arrangement if the assets are located outside of the United States or (ii) at the time such assets are subsequently transferred outside of the United States. This rule applies even if the assets remain available to satisfy the claims of general creditors of the employer. This rule does not apply to assets located in a foreign jurisdiction, however, if substantially all of the services to which the nonqualified deferred compensation relates were performed in such foreign jurisdiction.[148]

Treasury and the IRS have requested comments and guidance concerning funding arrangements involving foreign trusts that do not result in improper deferral of U.S. income tax or do not effectively place assets beyond the reach of creditors.

2. Transfer of Assets in Connection with a Change in the Employer's Financial Health

A transfer of property in connection with the performance of services for purposes of Section 83 will be deemed to occur upon the earlier of (i) the date that the plan first provides that assets will become restricted to the provision of benefits under the plan in connection with a change in the employer's financial health, or (ii) the date on which assets are so restricted. This rule applies even if the assets remain available to satisfy the claims of the employer's general creditors.[149]

The AJCA Conference Report indicates that this provision is not intended to apply where assets are restricted for reasons unrelated to the employer's financial health (such as upon a change of control) or where assets are restricted pursuant to a structured schedule and a scheduled restriction happens to coincide with a change in the employer's financial condition.[150]

3. Effective Date and Transition Relief.

These restrictions with respect to offshore trusts and financial triggers became effective as of January 1, 2005, even with respect to amounts that were vested prior to that date. However,

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148 Code § 409A(b)(1).

149 Code § 409A(b)(2).

150 H.R. Conf. Rep. 108-755 at 720.

the Department of the Treasury granted transition relief under which taxpayers may rely on a reasonable good faith interpretation of Section 409A(b) to determine whether an arrangement is subject to taxation under Section 409A until further guidance is issued. In addition, no taxation will be triggered under Section 409A(b) with respect to any assets set aside, transferred or restricted on or before March 21, 2006 if on or before December 31, 2006 the plan comes into compliance with Section 409A(b) and any guidance issued thereunder.[151]

4. Restrictions for Employers Maintaining Underfunded Defined Benefit Plans.

The Pension Protection Act of 2006 amended Section 409A to add new restrictions on funding nonqualified deferred compensation for certain employers that have an underfunded defined benefit plan within their controlled groups. The new restrictions provide that if, during the "restricted period" with respect to a qualified defined benefit plan, (i) any assets that are set aside or reserved (directly or indirectly) or similar arrangement for purposes of paying nonqualified deferred compensation maintained by the employer that maintains the defined benefit plan or any member of the plan sponsor's controlled group or (ii) a nonqualified deferred compensation plan maintained by a plan sponsor or any member of its controlled provides that assets will become restricted under the plan in connection with the restricted period (or similar financial measure determined by the Department of Treasury) or the assets are so restricted, then such assets will be treated as a transfer of property for purposes of Section 83 of the Code.[152]

The "restricted period" with respect to defined benefit plan is (i) the period during which the plan is "at risk" as defined in Section 430(i) of the Code, (ii) the period during which the plan sponsor is a debtor in bankruptcy, or (iii) the 12 month period beginning 6 months prior to the termination of the defined benefit plan if, as of the termination date, the plan assets are not sufficient to satisfy all of its benefit liabilities.[153]

If an employer provides a tax gross up payment to an individual who is (i) the CEO or one of the 4 other highest paid executive officers of a publicly traded company or (ii) an individual who is subject to the reporting requirements under Section 16(a) of the Securities Exchange Act of 1934 (a "covered employee"), then the tax gross up payment will be taxable under Section 409A as if it were part of the deferred compensation to which the tax gross up payment relates, and the employer will not be entitled to deduct the tax gross up payment.[154]

These restrictions apply to transfers of assets or other reservations of assets made after August 17, 2006.

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151 Notice 2006-33.

152 Code § 409A(b)(1)(3)(A).

153 Code § 409A(b)(3)(B).

154 Code § 409A(b)(3)(C).

5. Amounts Treated as Transferred for Purposes of Section 83.

If any amounts are treated as transferred for purposes of Section 83 by reason of Section 409A(b), any increase in the value of, or earnings on, such assets during any taxable year will be also treated as an additional transfer of property subject to Section 83.[155]

I. Effective Date and Grandfathered Deferrals

In general, the provisions of Code Section 409A apply to amounts deferred prior to December 31, 2004. Code Section 409A will also apply to amounts deferred prior to January 1, 2005 if the plan under which such amount was deferred is materially modified after October 3, 2004.[156]

An amount will be treated as deferred prior to January 1, 2005 if (i) the service provider has a legally binding right to the amount and (ii) the right to the amount is both earned and vested before January 1, 2005. A service provider will not be treated as having a legally binding right to an amount if the service recipient retains discretion to reduce the amount of the payment. An amount will be considered earned and vested only if it is not subject to a substantial risk of forfeiture (as defined in Treasury Regulation Section 1.83-3(c)) or a requirement to perform further services.[157]

If Code Section 409A does not apply to an amount that is deferred prior to January 1, 2005, earnings with respect to such amount that are credited after December 31, 2004 will not be subject to Code Section 409A.[158]

1. Determination of the Amount Deferred Prior to January 1, 2005

The determination of the amount deferred prior to January 1, 2005 depends on the type of plan under which such amount was deferred.

(a) Nonaccount Balance Plan. In the case of a nonaccount balance plan (i.e., a defined benefit type plan), the amount deferred prior to January 1, 2005 is the present value as of December 31, 2004 of the vested benefit that the participant would receive if the participant separated from service on December 31, 2004 and commenced distributions of the benefits with maximum value available under the plan as of the earliest possible date allowed under the plan following a termination of employment.[159]

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155 Code § 409A(b)(4).

156 Notice 2005-1, Q&A-16(a); Prop. Treas. Reg. § 1.409A-6(a)(1).

157 Notice 2005-1, Q&A-16(b); Prop. Treas. Reg. § 1.409A-6(a)(2).

158 Notice 2005-1, Q&A-16(a); Prop. Treas. Reg. § 1.409A-6(a)(1).

159 Notice 2005-1, Q&A-17(a); Prop. Treas. Reg. § 1.409A-6(a)(3)(i).

Notice 2005-1 provides that the present value does not include the value of any subsidy (e.g., subsidized early retirement benefit) unless the participant would have been entitled to receive the subsidy if the participant separated from service on December 31, 2004.[160] In addition, Notice 2005-1 provides that the present value of the grandfathered deferrals as of December 31, 2004 will be determined using the actuarial assumptions specified in the plan if such assumptions are reasonable. If the plan does not specify the actuarial assumptions or if the actuarial assumptions specified in the plan are not reasonable, then reasonable actuarial assumptions must be used.[161] The amount of earnings attributable to the amounts deferred under a nonaccount balance plan prior to January 1, 2005 includes increases in the present value of the amount deferred prior to January 1, 2005 that are attributable solely to the passage of time using the same interest rate that was used to determine the amount deferred prior to January 1, 2005. Increases in the present value of the benefit attributable to additional service or increases in final average pay after December 31, 2004 and increases in the present value attributable to the attainment after December 31, 2004 of the right to a subsidized early retirement benefit (or similar subsidy) will not be treated as earnings attributable to amounts deferred prior to January 1, 2005.[162]

The Proposed 409A Regulations modify the determination of the grandfathered amount to permit the grandfathered amount to increase in subsequent years if the increase is not related to the provision of additional services or the occurrence of an event after December 31, 2004.[163] Thus, for instance, this change would allow the grandfathered benefit to include the value of a subsidy that a participant earns after December 31, 2004 by virtue of advancing age after 2004. The Proposed 409A Regulations also do not include any provisions relating to the actuarial assumptions used for purposes of determining present value.

(b) Account Balance Plan. The amount deferred prior to January 1, 2005 under an account balance plan is the vested account balance as of December 31, 2004.[164]

Earnings on amounts deferred prior to January 1, 2005 under an account balance plan include the actual or notional earnings credited with respect to the account balance as of December 31, 2004 (including earnings on such earnings).[165]

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160 Notice 2005-1, Q&A-17(a).

161 Id.

162 Notice 2005-1, Q&A-17(d).

163 Prop. Treas. Reg. § 1.409A-6(a)(3)(i).

164 Notice 2005-1, Q&A-17(b); Prop. Treas. Reg. § 1.409A-6(a)(3)(ii).

165 Notice 2005-1, Q&A-17(d); Prop. Treas. Reg. § 1.409A-6(a)(3)(ii).

(c) Other Plans (Equity-Based Compensation). For purposes of determining the amount deferred under an equity-based compensation arrangement prior to January 1, 2005, the equity-based compensation arrangement is treated like an account balance plan. The account balance in this case is the amount or value of the payment available (or the amount or value of the payment that would be available on December 31, 2004 with respect to a stock option, SAR or similar right, if it were immediately exercisable). For this purpose, the exercise price is disregarded. For example, if a service provider has a vested discounted stock option to purchase 1,000 shares of stock as of December 31, 2004, the amount deferred prior to January 1, 2005 is the fair market value of the 1,000 shares of stock underlying the vested stock option.[166]

The earnings attributable to amounts deferred prior to January 1, 2005 under a stock option, SAR or other equity-based plan is the amount of appreciation in the underlying stock after December 31, 2004. Thus, for example, if a discounted stock option to purchase 1,000 shares of stock was vested as of December 31, 2004, any appreciation in the value of the 1,000 shares of stock underlying the stock option would be treated as earnings attributable to the vested stock option.[167]

2. Material Modification

If a plan is materially modified after October 3, 2004, Code Section 409A will generally apply to all amounts deferred under such plan, including amounts deferred prior to January 1, 2005. A modification to a plan will be considered material if a benefit or right existing as of October 3, 2004 is enhanced or a new benefit or right is added after October 3, 2004. It does not matter whether the enhancement or addition is made pursuant to an amendment to the arrangement or pursuant to the service recipient's exercise of discretion. Examples of material modifications include amending a plan to add a new distribution option (e.g., adding the right to withdraw compensation subject to forfeiture of 10% of the amount withdrawn) or an acceleration of vesting to a date prior to January 1, 2005.[168]

However, the exercise of discretion by the service recipient over the time and manner of the payment of benefits will not be treated as a material modification to the extent that the service recipient had such discretion under the terms of the plan in effect as of October 3, 2004. Similarly, a plan will not be treated as materially modified merely because the plan is amended to add new investment choices or to change investment choices that qualify as predetermined actual investments within the meaning of Treasury Regulation 31.3121(v)(2)-1(d)(2)). In addition, the reduction of an existing benefit will not be considered a material modification.[169]

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[166] Notice 2005-1, Q&A-17(c); Prop. Treas. Reg. § 1.409A-6(a)(3)(iii).

[167] Notice 2005-1, Q&A-17(d).

[168] Notice 2005-1, Q&A-18(a); Prop. Treas. Reg. § 1.409A-6(a)(4)(i).

[169] Notice 2005-1, Q&A-18(a); Prop. Treas. Reg. §§ 1.409A-6(a)(4)(i) & (iv).

An amendment of a plan to conform with the requirements of Code Section 409A will not be treated as a material modification unless the amendment adds a new benefit or enhances an existing benefit.[170] For this purpose, a plan amended pursuant to the transition relief described in Subsection J below to allow a participant to elect to terminate his participation in the plan prior to December 31, 2005 will be treated as a material modification (even if the participant does not elect to terminate his participation in the plan) thereby destroying the grandfathered treatment for the amounts deferred under the plan prior to January 1, 2005.[171]

The adoption of a new arrangement or the grant of an additional benefit under an existing arrangement after October 3, 2004 and before January 1, 2005, will be presumed to be a material modification; provided that the grant of an additional benefit that consists solely of the deferral of additional amounts not previously provided under the plan will be treated as material modification only as to the additional deferrals. The presumption that the grant of additional benefits after October 3, 2004 is a material modification may be rebutted by showing that the grant was consistent with the service provider's past compensation practices.[172]

A plan will not be treated as having been materially modified if it is amended on or before December 31, 2005 to terminate the plan and distribute all of the benefits under the plan if all benefits deferred under the plan are included in the service providers' income in the taxable year in which the plan is terminated.[173] In addition, an amendment to suspend future deferrals under the plan will not be treated as a material modification.[174] The Proposed 409A Regulations clarify, however, that the cessation of deferrals under, or termination of, a plan pursuant to its terms is not considered a material modification.[175]

Notice 2005-1 provides that the cancellation of a stock option or SAR that would be considered deferred compensation for purposes of Code Section 409A will not be treated as a material modification if (i) it is replaced with a new option or SAR that would not have constituted deferred compensation under Code Section 409A if it had been granted on the original date of grant of the replaced option or SAR, (ii) the cancellation of the original grant and issuance of the replacement grant occurs on or before December 31, 2006,[176] (iii) the number of shares underlying the new stock options or SARs correspond directly with the number of shares

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[170] Notice 2005-1, Q&A-18(a); Prop. Treas. Reg. § 1.409A-6(a)(4)(i).

[171] Prop. Treas. Reg. § 1.409A-6(a)(4)(iii).

[172] Notice 2005-1, Q&A-18(b); Prop. Treas. Reg. § 1.409A-6(a)(4)(ii).

[173] Notice 2005-1, Q&A-18(c).

[174] Notice 2005-1, Q&A-18(c); Prop. Treas. Reg. § 1.409A-6(a)(4)(iii).

[175] Prop. Treas. Reg. § 1.409A-6(a)(4)(iii).

[176] Notice 2005-1 originally required that the cancellation and reissuance of the option or SAR occur on or before December 31, 2005. The preamble to the Proposed 409A Regulations extended this period until December 31, 2006 but only to the extent that the cancellation and reissuance does not result in the cancellation of a deferral in exchange for cash or vested property in 2006.

underlying the replaced options or SARs and (iv) the new stock option or SARs do not provide any additional rights (other than the benefit of changing the grant to a form that is not treated as deferred compensation).[177] For example, if a stock option that was granted with an exercise price below the fair market value of the stock underlying the option is amended on or before December 31, 2005 to increase the exercise price to the fair market value of the stock as of the date of grant, the amendment of the stock option will not be treated as a material modification.

The preamble to the Proposed 409A Regulations clarify that a service recipient may compensate service providers for the lost discount through a separate arrangement that either is not subject to Code Section 409A or otherwise meets the requirements of Code 409A. For instance, the service recipient could provide the service provider with a right to receive a payment (in cash or property) equal to the value of the lost discount (including earnings) subject to the same vesting schedule applicable to the options or SARs. If the payment is made or the property becomes vested in a future year and otherwise meets the conditions for the exclusion for short-term deferrals, the payment of the cash or vesting of the property would not be subject to the requirements of Code Section 409A. Alternatively, if the arrangement provides for further deferral of such amount if the requirements of Code Section 409A are otherwise met with respect to such payments, then such payment would not be considered a short term deferral. Note, however, that if the option or SAR is cancelled and replaced with a nondiscounted option or SAR in 2006, the service provider may not receive a payment of cash or vested property in 2006 for the lost discount.

3. Definition of Plan for Purposes of Determining Grandfathered Deferrals

For purposes of applying the grandfather rules the provisions treating all similar plans (i.e., account balance plans, nonaccount balance plans and all other plans) as a single arrangement does not apply. Accordingly, if a service provider benefits under more than one similar arrangement, a material modification to one such arrangement should not cause other similar arrangements to be treated as materially modified.[178]

J. Transition Relief

Notice 2005-1 provides broad, liberal transition relief giving service providers and service recipients through December 31, 2005 to review the new requirements under Code Section 409A and either modify existing deferral arrangements to comply with the new requirements, terminate such arrangements or allow service providers to terminate participation in such arrangements. In addition, given the extent of the changes required by the enactment of Code Section 409A, Notice 2005-1 also provided transition relief that permits service providers to change their deferral elections with respect to compensation for services performed on or before December 31, 2005.

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177 Notice 2005-1, Q&A-18(d).

178 Notice 2005-1, Q&A-18(e); Prop. Treas. Reg. § 1.409A-6(a)(3)(v).

Due to the substantial additional guidance contained in the long-delayed Proposed 409A Regulations, the Treasury Department extended the transition relief provided under Notice 2005-1 through December 31, 2006 with a few exceptions as discussed below.

1. Amendment of Plans Adopted Before December 31, 2006

Notice 2005-1 provides that a plan adopted before December 31, 2005 will not be treated as violating the requirements of Code Section 409A(a)(2), (3) or (4) (relating to deferral elections, distribution restrictions and prohibition on acceleration of distributions) if: (i) the plan is operated in good-faith compliance during the 2005 calendar year, and (ii) the plan is amended on or before December 31, 2005 to conform with the requirements of Code Section 409A or to provide a compensation arrangement that is not subject to Code Section 409A. The amendment does not need to apply to grandfathered deferrals or to other amounts that are not subject to Code Section 409A such as restricted stock, incentive stock options and nonqualified stock options that are not treated as deferred compensation.[179] The preamble to the Proposed 409A Regulations extended the transition period until December 31, 2006.[180]

Pursuant to the transition relief granted under Notice 2005-1 (as extended by the preamble to the Proposed 409A Regulations), a plan may be amended to allow plan participants to make a new distribution election with respect to amounts deferred prior to the election and the election will not be treated as violating the deferral election rules under Code Section 409A(a)(4) or the prohibition against acceleration of distributions under Code Section 409A(a)(3); provided that the plan is amended and the election is made before December 31, 2006, except that if the plan is amended after December 31, 2005, the participant may not make an election to the change in timing and form of payment with respect to any payments the service provider would otherwise receive in 2006 or cause any payments to be paid in 2006.[181] Thus, for instance, the plan may be amended in 2005 or 2006 pursuant to this transition rule to allow participants to change the date on which distributions will commence (to an earlier or a later date), add or remove events upon which the payments will be made (e.g., for instance by providing that payments will be made upon the occurrence of a change of control event) and/or change the form of payment (e.g., from installments to a lump sum) as long as an election made in 2006 does not cause the participant to defer a payment he or she would have otherwise received in 2006 or to cause any other payment to be paid in 2006. Likewise, an outstanding SAR may be amended to provide a fixed payment schedule consistent with the requirements of Code Section 409A.

Notice 2005-1 provides additional transition relief for nonqualified deferred compensation plans providing that the time and form of distribution are controlled by an election with respect to the time and form of distribution elected under a qualified retirement plan. Such linked elections do not comply with the distribution and election requirements of Code Section

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[179] Notice 2005-1, Q&A-19(a).

[180] Preamble to Proposed 409A Regulations.

[181] Notice 2005-1, Q&A-19(c); Preamble to Proposed 409A Regulations.

409A. Notice 2005-1 provides, however, that distributions under such a linked arrangement prior to December 31, 2005 will not violate Code Section 409A if the distribution is made in accordance with the terms in of the arrangement as in effect on October 3, 2004.[182] The preamble to the Proposed 409A Regulations extended this relief for distributions commencing prior to December 31, 2006.

2. Termination of Participation or Cancellation of Outstanding Deferral Elections

Notice 2005-1 provides that a plan adopted before December 31, 2005 may be amended to allow a participant to terminate participation in the plan or cancel an outstanding deferral election without causing the plan to violate the requirements of Code Section 409A(a)(2), (3) or (4) (relating to deferral elections, distribution restrictions and prohibition on acceleration of distributions) and without causing the amounts subject to the election to be includable in income under the doctrine of constructive receipt; provided that (i) the amendment is adopted and becomes effective on or before December 31, 2005 and (ii) the amounts subject to an election to terminate participation in the plan or to cancel a deferral election are includable in the participant's income in 2005 (or to the extent that the amount is not vested, in the year in which the amount vests).[183]

The service recipient is not required to offer the right to terminate participation or cancel an outstanding deferral election to any service providers and if the right is offered there is no requirement that the right be extended to all service providers. In addition, the termination of participation and/or cancellation of an outstanding deferral election may be undertaken at the discretion of the service recipient or at the election of the service provider.[184]

Furthermore, the relief accorded under this transition rule also allows for partial terminations and partial cancellations of outstanding deferral elections.[185] For example, this transition rule could be used to allow a participant to cancel his participation in the plan and receive a distribution of all amounts previously deferred under the plan in 2005 (or, if later, when such amounts vest) or partially cancel his participation in the plan and receive a partial distribution of the amounts deferred under the plan (while continuing to defer distribution of the remaining portion). In addition, this transition relief could be used to allow a participant to cancel a deferral election and completely eliminate such deferrals or merely reduce the amount being deferred pursuant to the deferral election. This rule may not, however, be used to increase the amount being deferred under the plan.

182 Notice 2005-1, Q&A-23.

183 Notice 2005-1, Q&A-20(a).

184 Id.

185 Notice 2005-1, Q&A-20(b).

Note that the Treasury Department has not extended this transition relief beyond December 31, 2005. Accordingly, to qualify for this relief the plan must be amended to permit participants to terminate their participation or cancel a deferral election no later than December 31, 2005 and the amount payable due to the termination of participation or cancellation of the deferral election must be included in the participant's gross income by the later of 2005 or the year in which the amounts are otherwise earned and vested.

3. Change in Prior Deferral Elections

A plan that was in existence on or before December 31, 2004 may also be amended to permit participants to change deferral elections that relate to services performed on or before December 31, 2005 without violating the initial deferral election requirements of Code Section 409A(a)(4)(B) and without causing the amounts subject to the new deferral election to be includable in income under the doctrine of constructive receipt if (i) the election is made on or before March 15, 2005, (ii) the amounts to which the deferral election relate have not been paid or become payable at the time of the election, (iii) the elections to defer compensation are made in accordance with the terms of the plan in effect on or before December 31, 2005 (other than the requirement to make a deferral election on or before March 15, 2005), (iv) the plan is operated in accordance with Code Section 409A, and (v) and the plan is amended to comply with Code Section 409A on or before December 31, 2005.[186]

Note that pursuant to this transition rule, a participant may make an initial deferral election or change an outstanding election to increase the amount deferred pursuant to the election. In addition, this transition rule may also be used to defer the 2004 and 2005 bonuses (even if the bonuses are not considered to be performance-based compensation for purposes of Code Section 409A).

This transition relief was not extended in the Proposed 409A Regulations.

II. Constructive Receipt

This Section describes the historical development of the long-standing constructive receipt principles that applies for purposes of determining the timing of the deferral of income for federal income tax purposes. Note that the requirements of Code Section 409A discussed above operate as an overlay of traditional constructive receipt principles but do not replace or overturn these principles. Deferred compensation that is subject to Code Section 409A must also comply with the constructive receipt principles described in this Section.

A. Statutory and Regulatory Framework

Section 451(a) of the Code provides that the amount of any item of gross income shall be included in gross income for the taxable year in which the taxpayer receives it, unless, under the

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186 Notice 2005-1, Q&A-21.

method of accounting used in computing taxable income, such amount is to be properly accounted for in a different period. Under the cash receipts and disbursements method of accounting (the "cash method"), amounts are includable in gross income in the taxable year in which they are actually or constructively received.[187]

The constructive receipt doctrine generally provides that if an individual has an unqualified right to receive income which is not subject to a substantial risk of forfeiture, or some other substantial restriction, the individual is taxed on such amount on the date that right first arises. The constructive receipt doctrine is set forth in Treasury Regulation Section 1.451-2(a) which states:

> Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so he could have drawn upon it during the taxable year if notice of intent to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

B. Internal Revenue Service Guidance

The principal IRS pronouncement concerning constructive receipt of nonqualified deferred compensation is Revenue Ruling 60-31.[188] In Revenue Ruling 60-31, the IRS stated:

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[187] See Treas. Reg. § 1.451-1(a).

[188] 1960-1 C.B. 174, modified by, Rev. Rul. 64-279, 1964-2 C.B. 121, and Rev. Rul. 70-435, 1970-2 C.B. 100. Rev. Rul. 60-31 sets forth five examples of possible nonqualified deferred compensation plans. The IRS determined that constructive receipt did not occur in three of these examples, but did occur in two.

a. Example (1) of Rev. Rul. 60-31, in which the IRS ruled that constructive receipt did not occur, dealt with an employment contract. Under the employment contract, a certain portion of the employee's compensation was to be credited to a reserve account (no trust was established). The reserve account was subject to the creditors of the employer and payments from the reserve account were made on the occurrence of specified events (e.g., termination of employment). The IRS ruled that such amounts paid out were included in the employee's gross income only upon his actual receipt of the amounts.

b. Example (2) was similar to example (1), except that the employee's reserve account was credited with interest. The contract also included a forfeiture provision whereby the employee forfeited the amounts remaining in his account if he engaged in certain acts (e.g., if he competed with the corporation after his termination of employment). The IRS ruled that this plan did not cause the employee to be in constructive receipt of the amounts in the year they were credited to his account nor did the plan confer an economic benefit upon the employee.

c. Example (3) takes examples (1) and (2) one step further by using two contracts. The first contract states that the corporation will pay certain royalties to the taxpayer. The second contract, entered into before payments under the first began, amended the method of payment. The IRS ruled that since the amended contract was signed before amounts under the first contract were paid, the taxpayer was not in constructive receipt of any amounts nor had an economic benefit been conferred on the taxpayer.

...(continued)

> Thus, under the doctrine of constructive receipt, a taxpayer may not deliberately turn his back upon income and thereby select the year for which he will report it. [citation omitted] Nor may a taxpayer, by private agreement, postpone receipt of income from one taxable year to another. [citation omitted]
>
> However, the statute cannot be administered by speculating whether the payer would have been willing to agree to an earlier payment. See, for example, J.D. Amend, et ux. v. Commissioner, 13 T.C. 178, Acquiescence, C.B. 1950-1,1; and C.E. Gullett, et al. v. Commissioner, 31 B.T.A. 1067, in which the court, citing a number of authorities for its holding, stated:
>
>> It is clear that the doctrine of constructive receipt is to be sparingly used; that amounts due from a corporation but unpaid, are not to be included in the income of an individual reporting his income on a cash receipts basis unless it appears that the money was available to him, that the corporation was able and ready to pay him, that his right to receive was not restricted, and that his failure to receive resulted from exercise of his own choice.

Consequently, it seems clear that in each case involving a deferral of compensation a determination of whether the doctrine of constructive receipt is applicable must be made upon the basis of the specific factual situation involved.

...(continued)

d. Example (4) took example (3) one step further. In example (4), the amendment to the contract called for an escrow account to be established. The IRS ruled that since the escrow account was an irrevocable transfer of funds in which the taxpayer was vested (i.e., the amounts were beyond the reach of the employer's creditors) the taxpayer was in taxable receipt of the amount transferred. The escrow account conferred an economic benefit upon the taxpayer.

e. Example (5) discusses a factual situation in which a boxer contracted to defer his receipt of the gross receipts from a fight. The IRS stated that, in this situation, the boxer was participating in a joint venture and that the income of a joint venture which is a partnership is taxed pursuant to Section 702 of the Code (and relevant regulations). Partnership income is included in the partner's gross income in the year the partnership receives it regardless of whether the partner himself actually receives the income. Therefore under the partnership rules, the taxpayer was in constructive receipt.

The facts of Ray S. Robinson v. Commissioner, 44 T.C. 20 (1965), mirror the facts of example (5) in Rev. Rul. 60-31. Robinson involved Sugar Ray Robinson's entitlement to receive the purse for one of his title fights on a deferred basis. The Tax Court rejected the IRS' determination in example (5) of Rev. Rul. 60-31 that the arrangement was a joint venture. In addition, the Tax Court held that since Sugar Ray Robinson's rights to the deferred amounts were no more than those of an unsecured creditor, he was not in constructive receipt of those amounts immediately after the fight. In light of the Tax Court's decision in Robinson, the IRS retracted example (5) of Rev. Rul. 60-31. In Rev. Rul. 70-435, the IRS acquiesced in the Robinson decision and replaced example (5) in Rev. Rul. 60-31 with an example concerning a theatrical performer in a joint venture.

In general, Revenue Ruling 60-31 establishes that deferred income will not be treated as constructively received if:

(1) the agreement to defer is entered into before the taxpayer has earned the compensation;

(2) the agreement specifies the time, the events or the circumstances under which the deferred compensation will be paid (e.g., upon termination of employment); and

(3) the deferred amounts are not placed in trust or escrow for the benefit of the taxpayer beyond the reach of the general creditors of the employer and such deferred amounts remain an unsecured contractual obligation of the employer.

The IRS announced, in Revenue Procedure 71-19[189] that it would issue advance private letter rulings concerning the application of the doctrine of constructive receipt to unfunded deferred compensation arrangements only if the initial election to defer compensation was made before the beginning of the period of service for which the compensation is payable. The IRS generally has regarded the period of service for purposes of this requirement as the calendar year for cash basis individual taxpayers.[190] In addition, Revenue Procedure 71-19 requires that if the plan permits elections other than the initial election (such as an election regarding the timing of distributions) to be made subsequent to the beginning of the service period, the plan must provide substantial forfeiture provisions that must remain in effect throughout the entire period of the deferral.

Revenue Procedure 71-19 was modified by Revenue Procedure 92-65[191] to provide that a deferral election may be made in the year in which the plan is first implemented if the employee makes an election within 30 days of the establishment of the plan and the election applies only to compensation for services rendered after the election. Similarly, in the first year in which a participant becomes eligible to participate in a previously implemented plan, the newly eligible participant may make an election to defer compensation for services to be performed subsequent to the election provided the election is made within 30 days after the date the employee becomes eligible.

Revenue Procedure 92-65 also established four additional requirements that must be satisfied before the IRS will issue an advance ruling concerning the application of the doctrine of constructive receipt to an unfunded deferred compensation arrangement:

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189 1971-1 C.B. 698, modified by, Rev. Proc. 92-65, 1992-2 C.B. 428.

190 Rev. Rul. 68-86, 1968-1 C.B. 184; Rev. Rul. 69-650, 1969-2 C.B. 106; Rev. Rul. 71-419, 1971-2 C.B. 220.

191 1992-2 C.B. 428.

(i) the plan must define the time and method for payment of deferred compensation for each event (such as termination of employment, regular retirement, disability retirement or death) that entitles a participant to receive benefits;[192]

(ii) the plan may provide for early withdrawal of benefits in the case of an "unforeseeable emergency", which must be defined in the plan as an unanticipated emergency that is caused by an event beyond the control of the participant or beneficiary and that would result in severe financial hardship to the individual if early withdrawal were not permitted, provided that any early withdrawal approved by the employer is limited to the amount necessary to meet the emergency;

(iii) the plan must provide that participants have the status of general unsecured creditors of the employer and that the plan constitutes a mere promise by the employer to make benefit payments in the future, the plan must provide that any trust created by the employer and any assets held by the trust to assist it in meeting its obligations under the plan will conform to the terms of the model "rabbi" trust described in Revenue Procedure 92-64, and the plan must state that it is the intention of the parties that the arrangements be unfunded for tax purposes and for purposes of Title I of ERISA; and

(iv) the plan must provide that a participant's rights to benefit payments under the plan are not subject in any manner to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, or garnishment by creditors of the participant or the participant's beneficiary.

Revenue Procedures 71-19 and 92-65 established procedural requirements that must be met before the IRS would issue an advance ruling concerning application of the doctrine of constructive receipt to a deferred compensation plan. However, these requirements did not constitute a substantive interpretation of the law governing that doctrine. Accordingly, failure to satisfy one or more of these requirements does not necessarily mean that compensation has been constructively received.[193] Rather, the particular features of the plan must be tested against the substantive law governing application of the doctrine of constructive receipt as it has developed, principally through case law.

Although the IRS has traditionally taken a fairly restrictive view of deferral agreements under the doctrine of constructive receipt, case law has proven significantly more generous to

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[192] Rev. Proc. 92-65 states that the plan may specify the date of payment or provide that payments will begin within 30 days after the occurrence of a stated event.

[193] Of course, the requirements imposed under Code Section 409A are substantive rules. Thus, with respect to any deferred compensation that is subject to Code Section 409A, the deferral elections and the timing of distributions must also comply with the requirements of Code Section 409A.

taxpayers. For instance in Commissioner v. Olmsted Inc. Life Agency[194] and Commissioner v. Oates,[195] the Seventh and Eighth Circuits each held that an agreement entered into by an insurance agent and an insurance company to defer the agent's receipt of renewal commissions did not result in constructive receipt even though the deferral agreement was entered into after all of the services giving rise to the renewal commissions had been performed.

In Veit v. Commissioner[196] (Veit I), the Tax Court held that compensation deferred to a later year pursuant to an amendment to an employment agreement did not result in constructive receipt of the accrued but unpaid compensation in the year in which such amounts would have been paid under the original agreement. Under the terms of the original employment agreement entered into in 1939, the employee was entitled to receive a percentage of the employer's 1940 profits payable in two equal installments in 1941. On November 1, 1940, the employee and the employer entered into a subsequent employment agreement under which the percentage of 1940 profits payable in 1941 under the original agreement would be paid in equal quarterly installments in 1942.[197] The Tax Court stated:

> The whole agreement of November 1, 1940, was an arms' length business transaction entered into by petitioner and the corporation which was regarded as mutually profitable to both. The only way we should be justified in holding that petitioner constructively received the $87,076.40 in 1941 would be to hold that the agreement to defer the payment of such $87,076.40 until 1942 was a mere subterfuge and sham for the purpose of enabling petitioner to postpone his income tax on the amounts involved to another year. The evidence does not justify such a holding, but, on the contrary, seems to establish that the agreement to defer the payments until 1942 was an arm's length contract, arrived at in the ordinary course of business.[198]

The employee and the employer in Veit I entered into a subsequent agreement on December 26, 1941, in which the $87,076.40 payable in 1942 was further deferred (with interest credited at 1-1/2% per annum) until 1943. The IRS challenged this subsequent deferral in Veit v. Commissioner[199] (Veit II) claiming that this amount was constructively received in 1942. The IRS sought to distinguish the Tax Court's earlier opinion in Veit I on the ground that at the time of the November 1, 1940 agreement, the amount of the 1940 profits had not been ascertained

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194 304 F.2d 16 (8th Cir. 1962).

195 207 F.2d 711 (7th Cir. 1953), acq. 1960-1 C.B. 5.

196 8 T.C. 809 (1947).

197 Id. at 811-12.

198 Id. at 816.

199 8 T.C.M. 919 (1949).

whereas the full amount had been ascertained and credited on the employer's corporate books as of the December 26, 1941 agreement. The Tax Court stated:

> We do not deem these differences material. <u>Under existing contracts there was never a time when the $87,076.40 was unqualifiedly subject to petitioner's demand or withdrawal.</u> He did not voluntarily refrain from collecting money available for him, nor did he agree to the debtor's deferred payment of money available when the agreements were made. (emphasis added).

Consequently, in <u>Veit II</u>, the Tax Court clearly established the principle that an agreement to extend a prior deferral of income does not trigger constructive receipt where the second deferral agreement is entered into before the amounts are payable under the first deferral agreement.

C. <u>The Tax Reform Act of 1978</u>

On February 3, 1978, the IRS sought to overturn the long-standing doctrine of constructive receipt by issuing Proposed Treasury Regulation Section 1.61-16, providing that compensation deferred at the election of an employee (even if the election is made irrevocably and unconditionally prior to the date the compensation is earned) will be taxable at the time such compensation would have been received in the absence of such an election. The proposed regulation stated:

> § 1.61-16. <u>Amounts payments of which are deferred under certain compensation reduction plans or arrangements</u> -- (a) <u>In general</u>. Except as otherwise provided in paragraph (b) of this section, if under a plan or arrangement (other than a plan or arrangement described in sections 401(a), 403(a) or (b), or 405(a)) payment of an amount of a taxpayer's basic or regular compensation fixed by contract, statute or otherwise (or supplements to such compensation, such as bonuses, or increases in such compensation) is, at the taxpayer's individual option, deferred to a taxable year later than that in which such amount would have been payable but for his exercise of such option, the amount shall be treated as received by the taxpayer in such earlier taxable year. For purposes of this paragraph, it is immaterial that the taxpayer's rights in the amount of which is so deferred become forfeitable by reason of his exercise of the option to defer payment.
>
> (b) <u>Exception</u>. Paragraph (a) of this section shall not apply to an amount payment of which is deferred as described in paragraph (a) under a plan or arrangement in existence on February 3, 1978, if such amount would have been payable, but for the taxpayer's exercise of the option, at any time prior to [date 30 days following publication of this section as a Treasury Decision]. For purposes of this paragraph, a plan or arrangement in existence on

> February 3, 1978, which is significantly amended after such date will be treated as a new plan as of the date of such amendment. Examples of significant amendments would be extension of coverage to an additional class of taxpayers or an increase in the maximum percentage of compensation subject to the taxpayer's option.

In response to a broad based outcry against the IRS' attempt by regulation to overturn long-standing judicial and administrative precedent, Congress in the Tax Reform Act of 1978 ("TRA '78") prohibited the IRS from changing the constructive receipt rules in effect on February 1, 1978 with respect to compensation paid by taxable entities.[200] Section 132(a) of TRA '78 provides in part that "[t]he taxable year of inclusion in gross income of any amount covered by a private deferred compensation plan shall be determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978."[201] Accordingly, by enacting this provision, Congress essentially froze the doctrine of constructive receipt as set forth in applicable regulations, rulings and judicial decisions in effect as of February 1, 1978.[202]

Although Section 885 of the AJCA does not expressly repeal Section 132(a) of TRA '78, it adds an additional new set of rigid requirements governing the timing of deferral elections and the timing of distributions of deferred compensation. Moreover, Section 885 of the AJCA expressly authorizes and directs the Secretary of the Treasury to issue guidance interpreting Section 409A of the Code. While the absences of any provision repealing Section 132(a) of TRA '78 coupled with the prospective effective date of Section 885 of the AJCA suggests that the determination of whether a person is in constructive receipt of compensation should continue to be analyzed under the applicable regulations, rulings and judicial decisions in effect as of February 1, 1978, the IRS may feel emboldened enough by the enactment of Code Section 409A to more aggressively assert constructive receipt in the future.

D. Case Law and Other Guidance Issued After The Tax Reform Act of 1978

In PLR 8632003 (Apr. 18, 1986) the IRS concluded that an election to further defer receipt of compensation which is not yet payable, but which has been earned and the amount of which is definitely ascertainable, should be disregarded in determining when such deferred compensation is taxable. This ruling involved a shadow stock plan pursuant to which an employee would be entitled to receive the value of his shadow stock units in a lump sum

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200 Deferred compensation plans of state and local governments and tax-exempt employers are governed by Code § 457 which imposes substantial limitations on such plans.

201 TRA '78 § 132(a), Pub. L. No. 95-600.

202 The statutory prohibition applied *only* to the constructive receipt rules and not to the economic benefit rules. Therefore, it becomes important to distinguish between the two rules, particularly when dealing with vesting, rabbi, and secular trusts.

payment following termination of employment. Alternatively, the employee could elect at any time prior to termination to instead receive the post-termination payment in ten annual installments with interest credited on the deferred amounts.

Concluding that "[a]s to amounts already earned and determinable, the subsequent and further deferral should not be recognized," the IRS sought to distinguish cases which permitted an election to defer compensation after services have been performed and before the compensation is payable. Oates was distinguished on the ground that while all of the services giving rise to the renewal commissions had been performed prior to the deferral election, the renewal commissions were contingent payments and therefore were not "earned" at the time of the election. Veit I and Veit II were distinguished on the ground that these cases arose in the context of bilateral negotiations in which both sides provided consideration.

The IRS did not cite any authority in PLR 8632003 for the proposition that an agreement to defer previously earned compensation which is not yet subject to payment must occur in the context of bilateral negotiations in which both sides provide consideration. Although the Tax Court in Veit I set forth the bilateral nature of the negotiations in that case, it appears that the Tax Court relied on these facts solely to determine whether the agreement to defer compensation was "a mere subterfuge and sham for the purpose of enabling petitioner to postpone his income tax."[203] Moreover, the determinative factor in the Tax Court's analysis in Veit II appears not to have been the bilateral nature of the negotiated deferral, but rather the fact that "there never was a time when the [deferred amount] was unqualifiedly subject to petitioner's demand or withdrawal."[204]

In Martin v. Commissioner,[205] the Tax Court concluded that two employees who elected installment payments under a shadow stock plan[206] shortly before the payments began, when they could have elected a lump sum, were not in constructive receipt of the value of the shadow stock. The two employees were participants in their employer's deferred compensation plan for key management employees. Under the terms of this plan, benefits were payable only in 10 equal annual installments.[207] In 1981, the company adopted a new shadow stock plan in which participants in the old deferred compensation plan could elect to participate by relinquishing rights under the old plan. Under the new shadow stock plan, benefits were payable in a lump sum unless the participant elected to receive payment in 10 annual installments. The election was generally required to be made prior to the termination of employment.[208] A participant

203 8 T.C. at 816.

204 8 T.C.M. 919.

205 96 T.C. 814 (1991).

206 Under the shadow stock plan, an executive would be awarded shares of "shadow stock" which he may surrender, upon the terms and conditions stated in the plan, for a cash payment in the amount of accumulated earnings per share of the company's common stock since the date of grant.

207 Id. at 816-17.

208 Id. 818-19.

under the new plan could elect to surrender his shadow stock shares at any time but would forfeit his rights to any unvested shares and would no longer be entitled to participate in the plan.[209]

Shortly after the new shadow stock plan was adopted, the two employees elected to participate in the new plan and to receive their benefits in 10 annual installments.[210] A short time thereafter (two weeks in one case, almost 4 months in the other) within the same year (1981), these employees terminated employment.[211] The IRS determined that the employees were in constructive receipt of the entire amount of their benefits under the shadow stock plan because they had an unfettered right to elect a lump sum benefit after electing into the new plan in 1981. The IRS argued that the election of installments by the participants "was both self-imposed and an insufficient restraint to preclude application of the doctrine of constructive receipt."[212]

The Tax Court held that the employees were not in constructive receipt of their benefits, either when they elected to participate in the new shadow stock plan or when they terminated employment. The Tax Court concluded that because the participants were required to elect between the lump sum and the installment options prior to the surrender date (the date on which the participants could surrender their shadow stock shares for redemption), they did not acquire an unconditional right to receive payment prior to such date.

> Because petitioners were limited to making the election prior to the surrender date, they did not acquire an unconditional right to receive payment prior to their respective surrender dates. Accordingly, the full amount of petitioners' shadow stock benefits was not due or payable upon terminating employment in 1981 because petitioners had elected to receive installment payments. [footnote omitted] The installment elections were made before petitioners acquired an unconditional right to receive payment of their benefits.[213]

The facts in Martin are substantially similar to those presented in PLR 8632002 (Apr. 18, 1986). In that ruling (discussed above) the IRS concluded that any election between a lump sum or installment method of payment of shadow stock shares which is made after the services giving rise to the deferred compensation has been earned results in constructive receipt of the lump sum payment amount when benefits under the plan become payable. This ruling is inconsistent with

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209 Id. at 819.

210 The plan's administrative committee interpreted the new plan to require that changes in elections as to the form of payment would become effective not earlier than the year following the year in which the election was made. However, these two individuals, upon electing the new plan, were given the right to select either a lump sum or installment payments without any delay in the effective date of the election.

211 Id. at 919-20.

212 Id. at 821.

213 Id. at 826.

the analysis in Martin and other applicable case law. See e.g., Goldsmith v. United States[214] (doctor's ability to terminate his deferred compensation agreement with a hospital upon 30 days notice did not render him in constructive receipt of the deferred compensation), and Veit v. Commissioner[215] (employee's election to extend the payment date of his deferred compensation prior to the date he had an unconditional right to receive payment did not result in constructive receipt).

In Childs v. Commissioner,[216] the Tax Court addressed a situation that involved a law firm that settled two personal injury cases. The attorneys had each executed fee agreements with the plaintiffs providing that, if the cases were settled before trial, the attorneys would receive 33-1/3 percent of the gross amount recovered in the litigation by the plaintiffs, and that if the cases were settled after trial, the attorneys were to receive 40 percent of the gross amount recovered.

The cases were eventually settled prior to trial. The settlement agreements provided for "structured settlements" which consisted of initial payments to the plaintiffs as well as periodic payments over a number of years from annuity contracts purchased by the defendant's insurers. As part of the settlement agreements, the defendant's insurance companies gave each of the three plaintiff's attorneys an option with respect to the payment of their respective legal fees. Each attorney selected a different payment arrangement, with one attorney collecting his entire fee within six months while the other two attorneys elected to receive lifetime annuity payments. All of the attorneys were cash method taxpayers and reported the fees for federal income tax purposes in the taxable year in which they were received.

On their 1986 and 1987 federal income tax returns, the attorneys only reported the amount of the cash payments they actually received under the annuity contracts. The IRS, however, determined that the attorneys had constructively received the fair market value of the annuity contracts in the taxable years in which the litigations were settled, and therefore, should have included the fair market value of the annuity contracts (i.e., the amounts that defendant's insurer paid for the annuity contracts) in their gross incomes for their 1986 and 1987 taxable years.

The Tax Court rejected the IRS' contention that the attorneys were in constructive receipt of the amounts paid for the annuity contracts. The Tax Court noted that a taxpayer constructively receives income when he has an "'unqualified vested right to receive immediate payment.'"[217] The Tax Court held that, because the attorneys were not entitled to their fees until the settlement agreements were binding and a judgment was entered, the attorneys, who were

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214 586 F.2d at 819 n.5.

215 8 T.C.M. 919 (1949).

216 103 T.C. 634 (1994), aff'd without published opinion, 89 F.3d 856 (11th Cir. 1996).

217 Id. at 654 (quoting Martin v. Commissioner, supra at 823).

cash method taxpayers, did not have a right to receive immediate payment, and therefore, did not constructively receive the amounts used to purchase the annuity contracts.[218]

The facts in Childs are substantially similar to those presented in TAM 9336001 (May 12, 1993). In that ruling, the IRS concluded that the attorneys were in constructive receipt of the premiums paid for the annuity contracts because there were "no 'substantial limitations or restrictions' on their right to receive [their] fees in cash, except those that were self imposed after the fees were earned." The IRS' analysis in TAM 9336001 is inconsistent with the Tax Court's analysis in Childs.

The IRS has recently successfully litigated two constructive receipt cases that help shed some light on the breadth of the courts' earlier cases in this area. In Sainte Claire Corporation v. Commissioner,[219] the Tax Court held that Sainte Claire Corporation ("Sainte Claire"), a cash method taxpayer which had elected S corporation status, was in constructive receipt of the principal amount of a promissory note that had been given to it by one of its shareholders in connection with the sale of property. In reaching its holding, the Tax Court distinguished Childs, Martin, and its other prior constructive receipt cases on the grounds that the taxpayers in those cases did not have an unconditional right to receive payment at the time of the deferral.

In 1968, Sainte Claire sold two prune ranches to James F. Boccardo ("Mr. Boccardo"). Mr. Boccardo assumed the existing mortgages on the ranches and gave Sainte Claire a promissory note, dated November 1, 1968 (the "1968 Note"), in the amount of $2,087,500 that bore interest at a rate of 6-1/2 percent per annum, payable semiannually, and provided for a balloon payment of the principal on or before November 1, 1988.

On November 1, 1988, the date the 1968 Note matured, Mr. Boccardo, at a meeting of the board of directors and shareholders of Sainte Claire, requested that the term of the 1968 Note be extended. In consideration for the extension, Mr. Boccardo offered to pay interest on the principal amount at a rate of 9 percent per annum. After a discussion by the board and the shareholders, the board unanimously approved Mr. Boccardo's proposal. Mr. Boccardo executed an unsecured promissory note, dated November 1, 1988 (the "1988 Note") in the amount of $2,087,500 that bore interest at a rate of 9 percent per annum, payable semiannually, and provided for a balloon payment of the principal on or before April 1, 1990. On April 1, 1990, Sainte Claire's board met and voted to extend the term of the loan one more year. Mr. Boccardo executed a promissory note on April 1, 1990 (the "1990 Note") that was due on or before April 1, 1991, but was otherwise made on the same terms as the 1988 Note. On April 1, 1991, Sainte Claire's board met again and voted to extend the loan until April 1, 1994. Mr. Boccardo executed a promissory note, dated April 1, 1991 (the "1991 Note"), that was due on or

[218] Id. at 655.

[219] T.C. Memo. 1997-171, aff'd sub nom. Boccardo v. Commissioner, 1998 U.S. App. LEXIS 24868 (9th Cir.).

before April 1, 1994, but otherwise contained the same terms as the 1990 Note. During 1993, Mr. Boccardo paid Sainte Claire the principal amount of the 1991 Note.

The Tax Court upheld the IRS' contention that Sainte Claire constructively received the principal amount of the 1968 Note in 1988, the year the principal amount of the 1968 Note was due. The Tax Court stated that "a taxpayer will be found to be in constructive receipt of income where the taxpayer had an unrestricted right to receive the income, the taxpayer was able to collect it, and the failure to receive it resulted from the taxpayer's own choice." The Tax Court held that the question of whether Sainte Claire constructively received the principal amount of the 1968 Note was a question of fact and that the record in the case showed that, at the time Sainte Claire's board voted to extend the terms of the 1968 Note, it had "an unqualified right to receive the principal amount" of the 1968 Note. The Tax Court distinguished its prior constructive receipt cases on the following grounds:

> While Mr. Boccardo discussed extending his note with members of Sainte Claire's board and others prior to the due date of the note, we are not persuaded by the record in the instant case that an agreement or understanding that the note would be extended existed prior to the vote of the board on November 1, 1988. Accordingly, the cases holding that a taxpayer may effectively defer for tax purposes receipt of income payable pursuant to an agreement by entering into a superseding agreement prior to the time the income is due pursuant to the terms of the original agreement, see e.g., Martin v. Commissioner, supra at 823-824; Oates v. Commissioner, 18 T.C. 570, 584-585 (1952), aff'd, 207 F.2d 711 (7th Cir. 1953); Veit v. Commissioner, 8 T.C. 809, 817-819 (1947); Kimbell v. Commissioner, 41 B.T.A. 940, 948-949 (1940), are not controlling in the instant case because the agreement to defer payment was not made until Sainte Claire's right to payment became vested.

The Tax Court also found that, because Mr. Boccardo had a net worth of approximately $50 million in 1988 and could have borrowed the principal amount of the 1968 Note from a third party lender, Mr. Boccardo could have paid the principal amount of the 1968 Note on November 1, 1988 had he been required to do so by Sainte Claire. Accordingly, the Tax Court held that Sainte Claire constructively received the principal amount of the 1968 Note in 1988, which it then re-advanced to Mr. Boccardo. Although the Tax Court held that Sainte Claire was in constructive receipt of the principal amount of the 1968 Note in 1988, the Tax Court's decision is consistent with its holdings in both Childs and Martin. In those cases, the Tax Court found that the taxpayers did not have an unqualified right to receive the income in question at the time of their election to extend the period of payment.

In Palmer v. Commission,[220] the Tax Court held that a consultant, James Palmer ("Palmer"), had constructively received certain payments in 1995 that he had elected to defer to later years. Palmer executed a consulting agreement with Olin Corporation ("Olin") on

[220] T.C. Memo. 2000-228.

September 12, 1994. Pursuant to the terms of the consulting agreement Palmer was to provide services under the direction of R.R. Harris ("Harris"), an Olin employee, and Palmer was entitled to receive $3,000 per week in fees plus reimbursement of expenses until March 31, 1995 and, thereafter, on a month-to-month basis, for a period of three months. Palmer was required to submit monthly invoices for services and expenses to Harris for approval and his fees and expenses would be paid within 30 days after Harris received the invoice. Pursuant to the procedures established by Olin, Harris would review the invoices and return the approved invoices, with any requested adjustments, to Palmer who would then submit the invoice to Olin's procurement coordinator who would determine whether the payment complied with the terms of the consulting agreement. If it did, the procurement coordinator would pay the invoice within 30 days after Harris received the initial invoice.

On March 22, 1995, at Olin's request, Palmer sent a memo identifying the conditions under which Palmer would agree to extend the term of his consulting agreement. Among the conditions set forth in this memo, Palmer requested "the right to postpone receipt by me of payment for any monthly invoice to a future date of my choosing, but in any case not later than January 31, 1997." Palmer also requested interest on any deferred payment.

Palmer submitted his invoices to Harris for February, March and April of 1995 on March 5, April 15, and May 7, respectively, but he did not submit the approved invoices to the procurement coordinator for payment until May 22, 1995. At that time he requested, in writing, that Olin not issue payments to him. He informed the procurement coordinator that he was working out a new arrangement with the company. The payment coordinator did not have Olin issue the payment checks right away but requested guidance from the Olin employee with whom Palmer was negotiating. On June 2, 1995, the procurement coordinator was instructed to honor Palmer's request to defer payment. Palmer submitted additional invoices for May and June of 1995 on June 6, and July 9, respectively. These invoices were promptly approved by Harris and Palmer submitted the approved invoices to the procurement coordinator with directions not to pay the invoices until he directed Olin to pay the invoices.

In July 1995, Palmer and Olin executed an amendment to his consulting agreement which extended the duration of the agreement and provided that Palmer's monthly invoices would be "paid within thirty (30) calendar days of the date of [Harris'] receipt [of the invoice], or deferred to a mutually agreed upon future date, but not later than January 31, 1997." The amendment also provided that the deferred payments would be credited with interest. The court found that Olin understood the amendment to mean that it would pay Palmer's invoices within 30 days after receipt of the invoice or at Palmer's direction on the date selected by Palmer.

At Palmer's direction, Olin paid Palmer's invoices for February, March and April of 1995 on January 11, 1996. Palmer's May 1995 invoice was paid on April 3, 1996 and his June invoice was paid on January 9, 1997. In addition, at Palmer's request his invoices for August through December of 1995 were paid on January 9, 1997.

The IRS issued a notice of deficiency for 1995 claiming that Palmer had constructively received payment in 1995 for his invoices for February through June of 1995 and for the estimated portion of his July 1995 invoice attributable to services performed before the execution of the amendment to the consulting agreement in July, 1995. Interestingly, the IRS did not issue a notice of deficiency with respect to the remainder of Palmer's July 1995 invoice or for his invoices for August through December of 1995. Although the IRS asserted at trial and in its briefs that Palmer was also in constructive receipt of these invoices, it did not seek to adjust the amount of the deficiency for 1995 to reflect those invoices.

In analyzing the application of constructive receipt to the facts of this case, the Tax Court noted that under the doctrine of constructive receipt, a cash-basis taxpayer will recognize income only if the taxpayer has "an unqualified, vested right to receive an immediate payment of income." The taxpayer may not, however, "deliberately turn his back on income otherwise available." Citing Oates, the Tax Court further observed, however, that if a taxpayer enters into a binding agreement to defer income before it is due, the taxpayer will not be in constructive receipt of that income until it is actually paid. Furthermore, the Tax Court cited Veit I for the proposition that a taxpayer may voluntarily defer the receipt of income by entering into a superseding binding agreement.

In applying these principles to the facts of this case, the Tax Court first observed that the original consulting agreement required Olin to pay Palmer's monthly invoices within 30 days after Palmer submitted his invoice to Harris. The court concluded that Palmer and Olin orally modified this agreement on June 2, 1995 when Olin agreed to defer the payment of the February, March and April 1995 invoices at Palmer's request. The court found that the consulting agreement, as modified on June 2, 1995, provided that the invoices would be "paid within thirty (30) calendar days of the date of [Harris'] receipt [of the invoice] or, at the direction of Consultant [Mr. Palmer], thereafter on a date selected by Consultant." Palmer asserted that he and Olin had modified his consulting agreement prior to June 2, 1995, but the court concluded that the evidence presented did not support this assertion.

The court held that because the terms of the original consulting agreement required Olin to pay each invoice within 30 days after Palmer submitted his invoice to Harris, the February and March 1995 invoices were due and payable before the June 2, 1995 modification of the original consulting agreement. Accordingly, the court concluded that Palmer had constructively received his February and March invoices in 1995.

With respect to the invoice for April 1995, the court concluded that Palmer and Olin had entered into a superseding agreement (the June 2, 1995 oral modification) before the date Palmer had an absolute and unconditioned right to receive the payment for April 1995. This invoice was submitted to Harris on May 7, 1995 and the 30-day period had not expired before the oral modification of the consulting agreement on June 2, 1995. Nevertheless, the Tax Court concluded that Palmer was in constructive receipt of the invoices for April, May and June of 1995 because the terms of the consulting agreement as orally modified on June 2, 1995, did not impose a substantial limitation or restriction on Palmer's control over the timing of his right to receive these invoices. According to the court, Olin was ready, willing and able to pay these invoices within 30 days after each invoice was submitted to Harris. All Palmer had to do to defer payment under the modified consulting agreement was direct Olin not to pay him. Although the court did not fully spell out the basis for this conclusion, it appears that the court concluded that Palmer had not entered into a binding agreement to defer the receipt of the payment to a specified date. Rather, it appears that Palmer simply requested Olin to hold the payments until such time as Palmer directed Olin to pay him. Accordingly, Palmer was in constructive receipt of the payment for these invoices 30 days after he submitted his invoice to Harris because after that date there was no restriction or limitation on Palmer's right to receive the payment. The court further concluded that the payment of the July 1995 invoice suffered from the same flaw. Although the July 1995 amendment to Palmer's consulting agreement provided that Palmer could defer receipt of payment for any invoice to a date that was mutually agreed upon by Palmer and Olin, the court found that, in operation, if Palmer wanted to defer payment of an invoice, all he had to do was direct Olin not to pay the invoice. The timing of the payment was totally within Palmer's control and Olin was ready, willing and able to pay each invoice. The court further noted that although the IRS had not sought to increase the amount of the deficiency for 1995 to reflect the deferral of payments due under the invoices for the balance of 1995, its holding applied with equal force to those deferred payments.

Despite the IRS' ruling position, the cases have firmly held that a binding agreement to defer compensation should not give rise to constructive receipt merely because the employer or service recipient is presently and immediately willing to pay the compensation agreed to be deferred, even where the predominant or sole motivating factor is the employee's tax advantage.[221] The Tax Court's holdings in Childs and Martin stand for the proposition that an election to defer compensation (including an election to extend the deferral period of previously deferred compensation) may be filed after the date the compensation is earned without triggering constructive receipt, provided that, at the time of the election, the compensation has not become unqualifiedly subject to the employee's demand or withdrawal. The key is that the election to defer must be made before an employee has an unconditional right to receive payment[222] and the election to defer must be a binding superseding contractual agreement that imposes a substantial limitation or restriction on the employee's right to control the receipt of the deferred compensation prior to the deferred payment date.[223]

E. Stock Appreciation Rights

It should also be noted that with respect to amounts deferred prior to January 1, 2005, the IRS has taken the position that an employee is not in constructive receipt of compensation merely because the employee receives stock appreciation rights ("SARs"), even after the employee is entitled to surrender the SARs for their accumulated value.[224] In general, a SAR provides that an employee is entitled to receive, upon surrender of the SAR, the difference between the price of a share of stock at the time the SAR is surrendered minus the exercise price (the price of a share of stock at the time the SAR is issued or some other fixed amount). An

221 See Goldsmith, 586 F.2d at 819. See also Martin v. Commissioner, 96 T.C. 814, 824 (1991); Robinson v. Commissioner, 44 T.C. 20, 36 (1965).

222 See Sainte Claire Corporation v. Commissioner, T.C. Memo. 1997-171.

223 See Palmer v. Commission, T.C. Memo. 2000-228.

224 See Rev. Rul. 80-300, 180-2 C.B. 165 (1980); Rev. Rul. 82-121, 1982-1 C.B. 79 (1982).

employee who surrenders his or her SARs for their surrender value also surrenders the right to benefit from future appreciation of the underlying stock without risking any capital. The loss of the right to future appreciation without risking capital is a substantial limitation on the employee's right to receive the surrender value of the SAR and thus precludes constructive receipt of the surrender value of the SAR.[225]

The potential for future appreciation with risk of capital is critical to the constructive receipt analysis for SARs. Thus, if the SARs provide a maximum surrender value, the employee will be in constructive receipt at the time the stock appreciates to point where the SAR reaches its maximum surrender value. For instance, suppose an SAR is issued with an exercise price of $10 per share and the SAR further provides that the maximum surrender value (i.e., stock price less exercise price) is $20. Once the stock price reaches $30 per share the SAR will have attained its maximum surrender value (i.e., $30 - $10 = $20). Because the employee would not be entitled to benefit from any additional appreciation in the value of the stock without risking capital, the employee's right to surrender the SARs for their maximum surrender value would not be subject to a substantial limitation. Accordingly, the employee would be in constructive receipt of the SARs' surrender value at the time the surrender value of the SARs reach their maximum.[226]

F. Conversion of Stock Options into Deferred Compensation.

A recent development in deferred compensation is the conversion of stock options into deferred compensation. An employee will receive taxable income upon exercise of a nonqualified stock option in an amount equal to the option spread (i.e., the difference between the fair market value of the stock on the date of exercise and the option price). An employee may determine the timing of the receipt of the taxable income by deciding when to exercise the option. However, stock options generally have a term of ten years or less. If the employee does not exercise the option during the term of the option, the option would expire and the employee would forfeit any income attributable to the unexercised options. Taxable income resulting from exercise of nonqualified stock options may be deferred beyond the option term, however, by allowing the employee to convert the stock option into deferred compensation. This conversion may be accomplished in either of two forms. For example, a plan may allow employees to make an advance election to receive phantom stock upon exercise of the option rather than actual stock. The phantom stock account could be payable to the employee at a predetermined time or upon the occurrence of a specified event (such as termination of employment) and could be settled in the form of stock or in cash.

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225 Rev. Rul. 80-300, 1980-2 C.B. 165 (1980).

226 Code Section 409A effectively precludes future grants of traditional SARs that permits immediate payout in a form other than publicly traded stock of the service recipient upon exercise of the SAR. Traditional SARs that permit payout in a form other than publicly traded stock of the service recipient upon exercise will not satisfy the new distribution rules imposed under Section 409A(a)(2). See Section I.C.2 above.

Alternatively, the stock option plan could allow employees to surrender their options prior to exercise in exchange for a deferred compensation account equal to the aggregate option spread. This approach was the subject of a recent favorable private letter ruling. In PLR 199901006 (Sep. 28, 1998), the IRS ruled that the employees would not be in constructive receipt of the value of stock options merely because the employees were provided an opportunity to surrender their stock options in exchange for deferred compensation. In this ruling, the parent company of a wholly owned subsidiary established a stock option plan under which the parent company issued both incentive stock options (as described in Code Section 422) and nonqualified stock options to employees of the subsidiary. Under the terms of the options, the option vested and became exercisable only if the employee remained employed by the subsidiary for a 3 to 5 year period.

In connection with the sale of a block of parent company stock to an unrelated purchaser, the parent company granted each employee the right to surrender his unvested options in exchange for an initial deferred compensation account equal to the difference between the price paid by the unrelated purchaser for each share of stock and the option price multiplied by the number of shares of stock the employee was entitled to purchase under the option. The price paid by the purchaser was represented to exceed the stock price as of the most recent appraisal prior to the sale. Each employee was required to make his election prior to the closing of the purchase of the shares by the unrelated purchaser. If an employee elected to surrender his stock options, the deferred compensation would be paid at the same time that the stock options would have vested had they not been surrendered. The ruling did not indicate whether interest or other investment earnings were credited to the participant's deferred compensation account. Under the terms of the plan, the employees were treated as general unsecured creditors of their employer with respect to their deferred compensation account.

The IRS ruled that neither the opportunity to surrender the options nor the actual surrender of the options would create an economic benefit or result in constructive receipt of taxable income to the employees. This ruling is actually quite narrow in scope because the stock options at issue were not vested and exercisable at the time of the election. Moreover, the election to surrender the options did not result in deferral of income because the deferred compensation continued to vest in accordance with original vesting schedule for the surrendered options and became payable to the employees at the time the options would have first vested and become exercisable. The key to this ruling appears to be that the employees did not have an unfettered right to receive the option spread at the time they were given the opportunity to surrender their options. Given the IRS ruling position, it is not clear that the IRS would have reached the same result if the employees were given the opportunity to elect to defer the receipt of the option spread after the options had become exercisable. As previously discussed, however, the IRS ruling position on constructive receipt is considerably more restrictive than substantive law. Moreover, an option may be analogized to an SAR. The surrender of the option would cause the employee to surrender the right to future appreciation in the value of the stock without risking capital. As with SARs, the potential for future appreciation is critical to the constructive receipt analysis. If an employee were to elect to surrender the option at or near the end of the option term, the employee’s right to surrender the option may not be subject to sufficient potential future appreciation to qualify as a substantial limitation on the employee’s right to the option spread at the time the employee elects to surrender the option. Thus, great care should be taken in structuring the deferral of the option spread.[227]

III. Economic Benefit

In Commissioner v. Smith,[228] the Supreme Court held that an economic benefit was conferred on an employee when he exercised a stock option granted by his employer. Upon exercise, a taxable transfer of property to the employee occurred, providing the employee with income equal to the difference between the option price and the fair market value of the stock on the date of exercise.

In Cowden v. Commissioner,[229] the Tax Court held that a taxpayer had received an economic benefit because the contractual promise to pay was a cash equivalent. The Tax Court held that the contract was a cash equivalent because it was assignable and convertible.

In E.T. Sproull v. Commissioner,[230] the Sixth Circuit held that an employer-created irrevocable trust of which the employee was the sole beneficiary was property set aside from the claims of the employer's creditors for the employee. Therefore, the employee received an economic benefit in the year in which the property was transferred into the trust. In Jacuzzi v. Commissioner,[231] the Tax Court also applied the economic benefit doctrine when holding that a taxpayer was required to include in income amounts transferred to a trust as compensation for services.

In Casale v. Commissioner,[232] the Second Circuit held that, because a corporation was the owner and beneficiary of a life insurance policy on the life of one of its employees and the life insurance policy was a general asset of the employer subject to the claims of the general creditors of the employer, the corporation had not conferred an economic benefit on the employee by purchasing the policy.

Sproull and the other applicable case law stand for the proposition that an employee will receive a taxable "economic benefit" in the taxable year cash or other property is transferred to a trust or escrow account which is outside the reach of the employer's general creditors and the employee's right to receive payment is not subject to any significant contingencies or is transferable by the employee. As stated above, the "economic benefit" doctrine has now been codified in Code Section 83 and the regulations thereunder.

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227 The enactment of Code Section 409A effectively precludes the conversion of stock options into deferred compensation. See Section I.C.3 above.

228 324 U.S. 177 (1945).

229 20 T.C.M. 1134 (1961), on remand from, 289 F.2d 20 (5th Cir. 1961), rev'g, 32 T.C. 853 (1959).

230 194 F.2d 541 (6th Cir. 1952), aff'g per curiam, 16 T.C. 244 (1951).

231 61 T.C. 262 (1973).

232 247 F.2d 440 (2d Cir. 1957).

More recently, the Tax Court, in Childs v. Commissioner, which is discussed above, rejected the IRS' contention that the attorneys' right to receive payments under the annuity contracts constituted "property" that was transferred in connection with the performance of services. In so holding, the Court focused on whether the promise to pay attorneys' fees under the settlement agreements and corresponding annuity purchases constituted "property" within the meaning of Section 83 of the Code. An unfunded and unsecured promise to pay money or property in the future is not considered "property" within meaning of Section 83.[233] The Tax Court, after analyzing case law under the economic benefit doctrine, held that funding does not occur as long as the obligor remains the owner of the fund and the fund remains subject to its general creditors. The Tax Court found that, because the payments under the settlement agreements could not be accelerated, deferred, increased or decreased, and because the defendant's insurers were owners of the annuity contracts, and as the owners of the annuity contracts they had the right to change the annuitant or beneficiary without the consent of the annuitant (i.e., the attorneys), the promises to make structured payments to the attorneys under the settlement agreements were not funded or secured by the obligors.[234] Accordingly, the Tax Court held that the promises to pay were unfunded and unsecured, and therefore, did not constitute "property" within the meaning of Section 83 of the Code.[235]

A. Parent Company Stock in a Rabbi Trust

The Treasury Department recently promulgated final regulations under Section 1032 of the Code which impacts rabbi trusts holding parent company stock if a subsidiary is considered a grantor of the rabbi trust. In general, under these regulations a subsidiary will not recognize gain or loss on the sale of parent company stock if:

(1) The subsidiary acquired the stock from the parent in a transaction in which (but for the application of the regulation) the basis of the parent company stock in the hands of the subsidiary would be determined, in whole or part, with respect to the parent company's basis in the stock;

(2) The subsidiary immediately transfers the stock in exchange for property or money to another person; and

(3) The person receiving the stock does not receive a substituted basis in the stock.[236]

The preamble to the final regulations indicated that the immediacy requirement described in (2) above would also apply to rabbi trusts. Thus, if a subsidiary is the grantor of a rabbi trust which acquires parent company stock, the subsidiary would recognize any gain or loss upon sale of the

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233 See Treas. Reg. § 1.83-3(e).

234 Id. at 651.

235 Id. at 653.

236 Treas. Reg. § 1.1032-3(c).

parent company stock unless the rabbi trust sells the parent company stock immediately after it acquires the stock. Thus, in order to ensure nonrecognition of gain or loss on the sale of the parent company stock held by a rabbi trust, the parent company must be considered the grantor of the trust. However, in order for employees of the subsidiary to avoid constructive receipt and economic benefit, the assets of a rabbi trust established by the subsidiary must remain subject to the claims of the general creditors of the subsidiary. The preamble to the final regulations under Code Section 1032 dismissed this apparent conflict by stating that the IRS and Treasury have determined that a subsidiary is not necessarily the grantor of a rabbi trust merely because the assets of a rabbi trust must remain subject to the claims of general creditors of the subsidiary.[237] The IRS recently issued additional guidance on the application of the immediacy requirement under Treasury Regulation Section 1.1032-3(c) to rabbi trusts. In Notice 2000-56,[238] the IRS formally announced that when a parent company contributes stock to a rabbi trust to assist its subsidiary in providing deferred compensation to employees of the subsidiary, the parent company will be treated as the grantor of the rabbi trust and the owner of any parent company stock held by the rabbi trust provided that the following two conditions are met:

(1) The stock held in the rabbi trust is subject to the claims of the creditors of both the parent company and the subsidiary;[239] and

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[237] T.D. 8883, 65 Fed. Reg. 31073 (May 16, 2000).

[238] 2000-43 I.R.B. 1 (October 6, 2000).

[239] Notice 2000-56, also provides that it is the position of the IRS that when a rabbi trust is established to provide benefits to employees of a subsidiary, the assets of the rabbi trust must be made subject to the creditors of the subsidiary even if the assets are also subject to the claims of the creditors of the parent company. We believe that the IRS position in this regard is incorrect. The IRS has informally taken the position that a parent company may guarantee the nonqualified deferred compensation obligation of a subsidiary without subjecting the employee to taxation under the principles of constructive receipt or economic benefit. See PLR 8509023 (November 29, 1984) (employees of subsidiary are not subject to income tax upon parent company's irrevocable guaranty of the subsidiary's deferred compensation obligation); see also Berry v. United States, 593 F. Supp. 80 (M.D.N.C. 1984), aff'd, 760 F.2d 85 (4th Cir. 1985) (irrevocable guarantee of a professional basketball player's deferred compensation by the owner of the team did not give rise to constructive receipt). If the irrevocable guaranty of a subsidiary's deferred compensation obligation by the parent company does not result in constructive receipt or economic benefit then the transfer of assets by the parent company to a rabbi trust should not result in constructive receipt or economic benefit as long as the assets remain subject to the creditors of the entity that contributes the assets. Thus, if the subsidiary contributes money to the rabbi trust and the trust assets are subject to the claims of the general creditors of the parent company but not those of the subsidiary, then the employees of the subsidiary should be viewed to be in constructive receipt because assets of the subsidiary have been set aside to pay the deferred compensation and are no longer available to satisfy the claims of the subsidiary's general creditors. Conversely, however, if the parent company contributes assets to the rabbi trust to meet its obligations under the guaranty, then there should be no constructive receipt or economic benefit because the rabbi trust assets contributed by the parent remain available to satisfy the claims of the parent company's general creditors. Accordingly, the IRS' insistence that the assets of the rabbi trust remain subject to the claims of the creditors of the employer on whose behalf the assets were made arguably focuses on the wrong issue. The focus of the inquiry should be on whether the employer or parent has secured the benefit by placing its assets beyond the reach of its creditors.

(2) The rabbi trust provides that any stock not transferred to employees will revert to the parent company upon termination of the trust.

Notice 2000-56 also provides that the IRS would not assert recognition of gain or loss by a subsidiary with respect to the sale or disposition of parent company stock from a rabbi trust for any parent company stock contributed on or before May 16, 2001 for any rabbi trust in existence on June 15, 2000. In addition, the Notice provides that if a rabbi trust is amended by May 16, 2001 to provide that the assets of the trust will be subject the claims of the general creditors of the parent company and to provide that any parent company stock not transferred to employees on termination of the trust will revert to the parent company, then the IRS will not treat the amendment as a constructive dividend.

B. Employee-Purchased Surety Bonds

Although an employer may not be able to secure an employee's benefits in a nonqualified deferred compensation plan without subjecting the employee to current taxation, the employee, himself, may be able to secure his benefits in the nonqualified plan by purchasing a surety bond. In PLR 8406012,[240] the IRS ruled that a surety bond purchased by an employee to protect his interest in an unfunded plan did not put the employee in constructive receipt of the benefits due him under the plan. The IRS did not address the Section 83 economic benefit theory aspects of this plan, and it is questionable whether the employer could have provided a surety bond with the employee as obligee since that would likely result in a transfer of property.

The impact of the distinction between an employee purchased surety bond and an employer purchased surety bond on whether the purchase of the surety bond confers an economic benefit was addressed in PLR 9344038.[241] Under this ruling the employee participated in an unfunded deferred compensation plan maintained by his employer. The employee purchased an insurance policy from an insurance company under which the insurance company agreed to pay the employee any unpaid deferred compensation upon the occurrence of an "Insured Event" specified in the policy. The insurance company would then be subrogated to the employee's rights under the deferred compensation plan. The terms of the policy were negotiated solely by the insurance company and the employee. The employer neither participated in these negotiations nor entered into any ancillary policy or any other contractual relationship with the insurance company. In addition, in issuing the policy, the insurance company relied solely on publicly available information about the employer; the employer did not provide any information to the insurance company other than publicly available information. The IRS ruled that:

> As a result of [the employee] independently obtaining the policy, [the employer] has not transferred property to [the employee] that is set aside

[240] PLR 8406012 (Nov. 3, 1983).

[241] PLR 9344038 (Aug. 2, 1993).

> from [the employer's] creditors for [the employee]. Since [the employee] negotiated the terms of, and obtained the policy without any involvement by [the employer], and [the insurance company] issued the policy without entering into any collateral agreements with [the employer] and without obtaining information about [the employer], other than publicly available information, no economic benefit has been conferred on [the employee] by the [employer].

The private letter ruling further indicated that the employer might increase the employee's compensation by an amount equal to the premium payments on the policy. The IRS noted that its conclusion above was based on the assumption that the payment of such additional compensation is not excludable from the employee's gross income as a working condition fringe benefit under Section 132 of the Code and is not deductible by the employee as a trade or business expense under Section 162 of the Code. The treatment of the additional compensation as a working condition fringe benefit, the IRS noted, would be inconsistent with the conclusion that the employer lacked any involvement in the employee's obtaining the policy. The IRS further opined that the payment of the premium by the employee was a nondeductible family expense under Code Section 262.

The IRS expressly noted that the issue is whether the employer has transferred property to the employee or has set aside assets beyond the reach of the employer's creditors. In concluding that the employer did not confer an economic benefit on the employee, however, the IRS apparently attempted to demonstrate that the employer in this ruling did not engage in any action or activity which, though not involving the transfer of any property, might nevertheless have conferred an economic benefit on the employee by way of reducing the cost of the insurance policy.

The IRS' focus on whether the employer provides the insurance company with non-public information is misplaced. The appropriate analysis under Code Section 83 and under the economic benefit doctrine is whether the employer has transferred any property (including any contractual rights) to the insurance company in exchange for the insurance company's agreement to issue the policy. For instance, if an employer transfers contractual rights (in addition to the subrogation of the employee's rights) to an insurance company in exchange for the insurance company's agreement to issue the policy to the employee, then the employer arguably would have conferred an economic benefit on the employee. The mere transfer of non-public information about the employer, without more (including without any contractual rights against the employer to provide additional information in the future, and without any representations, warranties or covenants concerning the validity of the information disclosed), should not constitute an economic benefit resulting in the inclusion in income of the deferred compensation secured by the surety bond.

IV. Employees of Tax-Exempt and Governmental Employers

A. General Requirements of Section 457(f) Plans

Code Section 457 governs the nonqualified deferred compensation plans of government and tax-exempt employers.[242] Code Section 457 was deemed necessary because the ordinary tension between the timing of the availability of a tax deduction for the corporation and the taxation of the employee does not exist for these type of employers. These employers would not be concerned about receiving a tax deduction for compensation paid to their employees.

In general, under Code Section 457, employees of a governmental or tax exempt organization will include nonqualified deferred compensation[243] in their gross income at the time the deferred compensation is no longer subject to a substantial risk of forfeiture, unless the compensation is deferred under an eligible deferred compensation plan described in Code Sections 457(a) though (e).

In general, an eligible deferred compensation plan described in Code Section 457(a) through (e) is an unfunded deferred compensation plan maintained by a governmental or tax-exempt organization which satisfies certain statutory requirements, including (i) restrictions on the maximum amount that may be deferred, (ii) restrictions on the timing of deferral elections, (iii) restrictions on the timing of distributions.[244] Eligible retirement plans maintained by tax-exempt organizations must remain unfunded and subject to the claims of the employer's general creditors.[245] However, eligible retirement plans maintained by state or local governments are required to be held in a trust, custodial account or annuity contract for the exclusive benefit of

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[242] Code Section 457 became applicable with respect to governmental employers effective for taxable years commencing after December 31, 1978, and with respect to other tax-exempt employers for taxable years commencing after December 31, 1986.

[243] The IRS in Notice 87-13, 1987-1 I.R.B. 432 and Notice 88-8, 1988 1 C.B. 477, has taken the position that the special rules under Code § 457 apply to all forms of nonqualified deferred compensation including compensation deferred under nonqualified defined contribution plans, nonqualified defined benefit plans, excess benefit plans and top-hat plans. In addition, Notice 88-8 provides that for taxable years commencing after December 31, 1987, nonqualified deferred compensation subject to Code § 457 includes nonelective nonqualified deferred compensation. However, Code § 457 does not apply to bona fide vacation leave, sick leave, severance benefits, disability pay or death benefits. See Notice 88-8.

[244] The Economic Growth and Tax Relief Reconciliation Act ("EGTRRA") increased the maximum amount that may be deferred under an eligible deferred compensation plan for any taxable years commencing after December 31, 2001. For 2004, the maximum amount that may be deferred under an eligible deferred compensation plan is limited to the lesser of 100% of the participant's taxable compensation or $13,000. The dollar limit will be increased to $14,000 for 2005, $15,000 for 2006. Thereafter, the $15,000 limit will be adjusted for cost of living increases. Code §§ 457(b)(2) and 457(e)(15). A special rule provides that during the last three taxable years ending before an employee's normal retirement date, the employee may defer up to the lesser of twice the applicable dollar limit for the year or the sum of the applicable limits for the current and all prior years (determined without regard to the special rule) reduced by the amount deferred for all prior years. Code § 457(b)(3).

[245] Code § 457(b)(6).

participants and beneficiaries.[246] A complete discussion of eligible deferred compensation plans is beyond the scope of this paper.

A deferred compensation plan sponsored by a governmental or tax exempt employer which does not meet the requirements of Code Sections 457(a) through (e), is typically referred to as a "Section 457(f) plan."

Note that while eligible deferred compensation plans are exempt from the new restrictions imposed on nonqualified deferred compensation imposed under Code Section 409A, Section 457(f) plans must satisfy both the new restrictions imposed under Code Section 409A and the risk of forfeiture restrictions imposed under Code Section 457(f).[247]

B. Section 457(f) Plans

If a governmental or tax exempt employer sponsors a deferred compensation plan that does not meet the requirements of Code Sections 457(a) through (e), Code Section 457(f) provides that the deferred compensation will be included in a participant's gross income in the first taxable year in which there is no substantial risk of forfeiture over the rights to such compensation.

A person's deferred compensation will be treated as subject to a substantial risk of forfeiture if the person's rights to the deferred compensation are conditioned upon the future performance of substantial services.[248] In determining whether an executive's deferred compensation is subject to a substantial risk of forfeiture, the IRS generally looks to the regulations and rulings issued under Code Section 83.[249] Treasury Regulation Section 1.83-3(c)(1) provides that a substantial risk of forfeiture exists where a person's rights in property transferred to the individual are conditioned directly or indirectly on the person's performance (or refraining from performing) of substantial services. An example in the regulations provides that a vesting provision that requires the completion of two years of service constitutes a substantial risk of forfeiture.[250]

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[246] Code § 457(g).

[247] See Section I above for a description of the new restrictions imposed on nonqualified deferred compensation under Code Section 409A.

[248] Code § 457(f)(3)(B).

[249] See, e.g., PLR 9211037 (Dec. 17, 1991) and PLR 9030028 (Apr. 27, 1990).

[250] Treas. Reg. § 1.83-3(c)(4)(Example 1). The IRS has issued numerous rulings under Code § 457(f) in which it has held that vesting conditions based on the performance of service for a period of at least two years generally constitutes a substantial risk of forfeiture for purposes of Code Section 457(f). See e.g., PLR 9444028 (Aug. 3, 1994) (vesting after 3 years); PLR 9430013 (Apr. 28, 1994) (5 years); PLR 9422038 (Mar. 4, 1994) (5 years); PLR 9329010 (Apr. 22, 1993) (3 years); PLR 9247011 (Aug. 21, 1992) (vesting upon attainment of stated age not less than two years after entry into the plan).

The IRS has also ruled that forfeiture only as a result of a participant's "for cause" termination or voluntary termination constitute substantial risk of forfeiture.[251]

A Section 457(f) plan may allow participants to direct the investment of their deferral accounts.[252] Earnings credited upon the compensation deferred under the plan generally will be includable in a participant's gross income when paid to or otherwise made available to the participant or his beneficiary, provided that the participant's or his beneficiary's interests in the plan's assets are not senior to employer's general creditors.[253] However, the earnings credited on the amounts deferred may be subject to earlier taxation as well additional penalties and interest if the Code Section 457(f) plan does not satisfy the requirements of Code Section 409A with respect to amounts deferred on or after January 1, 2005.[254] Distributions from the plan are taxable to the participant or his beneficiary under Code Section 72, provided that the participant's or his beneficiary's interests in the plan's assets are not senior to employer's general creditors.[255]

The IRS has in the past sent mixed signals regarding whether an employee and an employer may agree to extend the period during which deferred compensation subject to Code Section 457(f) is subject to a substantial risk of forfeiture and thus, delay the date on which such deferred compensation is includable in gross income. In PLR 9431021 (May 6, 1994), the IRS ruled that an employee would not need to include in his gross income the value of certain nonvested shares of restricted stock upon postponement of the vesting dates of such stock.[256] The employee in that ruling had received three transfers of stock which were to vest, in increments of one third of the total number of shares granted, on the anniversary date of each of the fifth, sixth and seventh years after grant. The shares of stock could not be transferred before becoming fully vested, and nonvested shares were forfeitable if the employee terminated employment for reasons other than death or disability, unless the employer waived the forfeiture.

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[251] See PLRs 199916037 (Jan. 25, 1999) and PLR 9815039 (Jan. 7, 1998).

[252] See PLR 9815039 (Jan 7, 1998) and PLR 9805030 (Nov. 7, 1997).

[253] Treas. Reg. § 1.457-3(a)(2).

[254] See Section I above. The requirements of Code Section 409A are generally applicable to amounts deferred under a nonqualified deferred compensation plan on or after January 1, 2005. Amounts deferred under a nonqualified deferred compensation plan prior to January 1, 2005 are not subject to the requirements of Code Section 409A unless the plan is materially modified after October 3, 2005. The legislative history of Code Section 409A indicates that an amount will not be considered deferred prior to January 1, 2005 unless the amount has been both earned and vested prior to January 1, 2005. Thus, if any amounts deferred under a Section 457(f) plan prior to January 1, 2005 were subject to a substantial risk of forfeiture on December 31, 2004, the requirements of Code Section 409A will apply to such amounts.

[255] Code § 457(f)(1)(B).

[256] While this ruling applied to the application of substantial risk of forfeiture exception to the taxation of property under Section 83 of the Code rather than to the taxation of deferred compensation under Code § 457, the ruling is relevant to the application of the substantial risk of forfeiture exception to the current taxation of deferred compensation under Code § 457(f) because, as noted above, the IRS looks to the regulation and ruling under Code § 83 to interpret the meaning of substantial risk of forfeiture under Code § 457.

Before the stock vested the employee and employer requested a ruling from the IRS on the tax consequences of postponing, or "rolling," the original vesting dates for periods extending seventeen to thirty-three months later.

In analyzing the proposed postponements, the IRS addressed the dual requirements of Code Section 83. First, the IRS determined that the restrictions to which the shares of stock would continue to be subject after postponement of vesting were sufficient to satisfy the requirement that, in order to avoid including the value of property received in return for services in gross income, the rights to such property must not be transferable. Second, in light of Code Section 83(c)(1) and the regulations thereunder, the IRS explained that the rights of a person to property are subject to a substantial risk of forfeiture if the person's rights to full enjoyment of the property are conditioned upon the future performance of substantial services by any individual. Based on this, the IRS concluded that:

> subject to the condition that the future services required of the Employee to avoid forfeiting the nonvested shares of Restricted Stock have been and continue to be substantial, . . . the postponement of the lapsing of restrictions on the transferability of the Restricted Stock and the prolongation of the period during which the Restricted Stock is subject to a risk of forfeiture will not cause the value of the Restricted Stock to be included in the gross income of the Employee under section 83 of the Code.

In Code Section 409A(e)(5), Congress expressly authorized the Secretary of the Treasury to issue guidance to permit a substantial risk of forfeiture to be disregarded. Although this authority is specifically granted under Code Section 409A rather than 457, it appears that Congress was concerned that the use of rolling risks of forfeiture may cause the risk of forfeiture to be illusory. Notice 2005-1 provides that any election or agreement to extend the period during which compensation is subject to a substantial risk of forfeiture will be disregarded for purposes of Code Section 409A. Thus, an extension of the period during which compensation is subject to a substantial risk of forfeiture for purposes of Code Section 457(f) would subject the 457(f) arrangement to the requirements of Code Section 409A, which will make it substantially more difficult for tax exempt organizations to structure long-term deferred compensation arrangements that do not subject the service provider to a substantial risk of forfeiture for lengthy periods.[257]

The IRS has also ruled, in PLR 199916037 (Jan. 25, 1999), that a deferred compensation plan maintained by a government-owned hospital ("hospital") could provide benefits under Sections 457(b) and 457(f) of the Code to a group of primary and specialty care physicians. The ruling is significant because it represents the first time the IRS has issued a ruling on a plan that provides benefits under both Section 457(b) and Section 457(f) of the Code. Under the Section 457(b) portion of the plan, the physicians were eligible to defer up to the legal limit established by Section 457 for eligible plans. (For 2000, the deferral limit for Section 457(b) plans was $8,000.) Amounts deferred under the Section 457(b) portion of the plan were to be contributed to a trust established pursuant to Code Section 457(g). Under the Section 457(f) portion of the

[257] See Section I.C.2.

plan, the hospital planned to contribute an amount totaling 6.7 percent of each participant's salary. A participant's right to receive benefits under the Section 457(f) portion of the plan is contingent upon the participant's employment with the hospital until the full completion of his employment contract or until death, total disability, retirement at age 70-1/2, or the termination of the participant's employment by the hospital other than for cause. The IRS ruled that the benefits provided under the Section 457(f) portion of the plan were subject to a substantial risk of forfeiture until the participant ended his employment with the hospital under the terms of his employment contract or until death, total disability, retirement at age 70-1/2, or the termination of the participant's employment by the hospital other than for cause.

In order to secure the benefits under the Section 457(f) portion of the plan, the hospital proposed establishing a trust that would be drafted to conform to the requirements of Revenue Procedure 92-64.[258] Under the terms of both the plan and the proposed trust agreement, all amounts deferred under the Section 457(f) portion of the plan, and the income attributable thereto, would remain the property of the hospital and would be subject to the claims of the hospital's general creditors at all times. The IRS ruled that, because the principal and the income of the proposed trust may be applied to discharge the hospital's legal obligations, the trust would be a grantor trust under Section 677 of the Code, and as such, the hospital would be treated as the owner of the trust assets for federal income tax purposes. As the trust assets would be subject to the hospital's general creditors, the IRS also ruled that contributions to the trust would not result in a transfer of property under Section 83, and therefore, the participants would not be subject to taxation until the substantial risk of forfeiture lapsed.

V. Three Party Deferral Arrangements

In PLR 9810005 (Dec. 3, 1997), the IRS approved the use of a three party deferred compensation arrangement as a funding vehicle for a nonqualified deferred compensation plan maintained by a taxable employer that performed services for a tax exempt employer. This arrangement allowed the taxable employer to have funds set aside to pay nonqualified plan benefits, to have the earnings on such funds grow on a tax-deferred basis, and to keep those funds beyond the reach of its creditors until the time they are distributed to it for disbursement to the plan's participants.

Under the facts of PLR 9810005, a taxable corporation employing physicians ("C") provided services to a tax-exempt healthcare organization ("H").[259] C maintained an unfunded, nonqualified retirement plan for those employees whose benefits under C's tax-qualified plan were limited by certain Code provisions (the "SERP"). To qualify for benefits under the SERP, an eligible employee had to satisfy two requirements: (1) he had to remain employed by C until

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[258] 1992-2 C.B. 422, discussed above in Section I.A.2.

[259] Although the ruling does not identify the parties, it is widely believed that the recipient of the ruling was Kaiser Permanente. Kaiser Permanente is one of the largest healthcare organizations in the country and is actually composed of two different entities. Kaiser is a tax-exempt entity which maintains a health plan and Permanente is a taxable corporation that employs the physicians who provide services to Kaiser's health plan.

the later of a specific age or complete at least 5 years of service with C (the "service requirement"); and (2) he had to survive until the latter of another specific age or the date that benefit payments were to commence under C's qualified plan (the "survivor requirement"). In the ruling request, H proposed establishing a grantor trust to which it would make contributions of amounts necessary to satisfy C's future SERP obligations. All amounts held in the trust were to be allocated to individual memorandum accounts established for the benefit of each of the employees who participated in the SERP. On a quarterly basis, the trust would pay C funds sufficient to cover C's payment obligations for that quarter under the SERP.[260]

Under the proposed trust agreement, the assets of the trust would revert back to H upon the occurrence of a number of stated events. For example, an employee's entire memorandum account balance would be forfeited if the employee terminated his employment with C before satisfying the service requirement. Trust assets would also be forfeited back to H if C voluntarily terminated its relationship with H, or if H terminated its relationship with C for cause. If H terminated its relationship with C without cause, all of the trust's assets would be distributed to C.

The IRS ruled that as long as an individual's memorandum account was subject to a substantial risk of forfeiture (i.e., until the participant satisfied the SERP's service requirement), the account would be treated as being owned by H, and therefore, would not be taxable to C. The IRS also ruled that once the substantial risk of forfeiture lapsed, the amounts allocated to the individual's memorandum account would be taxable to C. The IRS reasoned that, because C would receive the economic benefit of the memorandum account, C should be subject to tax when the substantial risk of forfeiture lapsed. As result of the IRS' ruling, C would generally become taxable on the value of a participant's memorandum account before the participant became eligible to receive benefits under the SERP. (In order to receive benefits under the SERP, a participant had to satisfy the survivor requirement.) The IRS did, however, rule that C's taxability had no bearing on when the participants were taxable on the value of their benefits. Consequently, the proposed arrangement allowed the funds contributed to the trust to grow on a deferred basis for a limited period of time (i.e., until the participant satisfied the SERP's service requirement).

In reaching these conclusions, the IRS first ruled that H's contributions to the trust would be subject to Section 83 of the Code. Section 83 governs the taxation of property transferred in connection with the performance of services. The definition of "property" for purposes of Section 83 consists of personal or real property and not money or an unsecured and unfunded promise to pay money in the future. The Regulations under Section 83 also provide that the term "property" includes a beneficial interest in assets (including money) transferred or set aside from the claims of the transferor's creditors, for example, in a trust or an escrow account.[261]

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[260] In the ruling, the IRS stated that H and C were independent entities that had negotiated on an arm's length basis. It is not clear from the ruling what impact, if any, this finding had on the conclusions reached by the IRS.

[261] Treas. Reg. § 1.83-3(e).

Accordingly, the IRS ruled that H's contributions to a trust in which C would have a beneficial interest would be a transfer of "property" within the meaning of Section 83.

Under Section 83, a transfer of property in connection with the performance of services will become taxable to the service provider when the property is no longer subject to a substantial risk of forfeiture. A substantial risk of forfeiture exists where the rights in the property that are transferred are conditioned, directly or indirectly, upon the performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to the purposes of the transfer, and the possibility of forfeiture is substantial if the condition is not satisfied.[262] The IRS ruled that the requirement that C perform substantial services for H did not create a substantial risk of forfeiture.[263] Rather, the IRS relied on the alternate rule in the regulations, which provides that a substantial risk of forfeiture is created where property rights are conditioned upon the occurrence of a condition related to the purpose of the transfer. The IRS stated that the purpose of H's transfer of property to the trust was to provide C with a source of money to fund its obligations under the SERP. The IRS reasoned that the condition that related to the purpose of the transfer was the participants' meeting the service requirement of the SERP. Thus, the IRS ruled that an individual's memorandum account would be subject to a substantial risk of forfeiture until the individual satisfied the SERP's service requirement.[264] The IRS also ruled that once an individual satisfies the SERP's service requirement, the substantial risk of forfeiture lapses and C becomes taxable on the amounts allocated to the individual's memorandum account.

Next, the IRS analyzed the proposed arrangement under the Code's grantor trust rules. Section 671 of the Code provides that where a grantor is treated as the owner of a trust, the income, deductions and credits attributable to the trust's assets must be applied when computing the grantor's taxable income. Section 677(a)(2) of the Code provides that the grantor will be treated as the owner of any portion of a trust whose income, without the approval or consent of any adverse party, is or, in the discretion of the grantor or a nonadverse party or both, may be held or accumulated for future distribution to the grantor. The IRS ruled that to the extent the memorandum accounts are subject to a substantial risk of forfeiture under Section 83, H will be treated as the owner of the accounts under the grantor trust rules. The IRS reasoned that as long as the memorandum accounts are subject to a substantial risk of forfeiture they could be

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[262] Treas. Reg. § 1.83-3(c).

[263] The IRS concluded, without explanation, that the possibility of a reversion of the trust assets to H if C voluntarily terminated the agreement or if H terminated the agreement for cause did not "give rise to a substantial risk of forfeiture under section 83 under these circumstances." Due to the long-standing and exclusive relationship between the parties, the IRS may have concluded that the risk of forfeiture (i.e., that C would not perform services for H) was not substantial.

[264] Interestingly, the IRS concluded, without explanation, that the survivor requirement did not give rise to a substantial risk of forfeiture. If, as stated in the ruling, the purpose of H's transfer to the trust was to provide C with a source of money to fund its SERP obligations, then one could reasonably argue that the requirement that a participant live to a certain age in order to receive benefits makes the transfer subject to the occurrence of a condition related to the transfer, and therefore, subject to a substantial risk of forfeiture.

distributed to H under the terms of the trust without the approval or consent of an adverse party. Consequently, the IRS ruled that H should be treated as the owner of the accounts for federal income tax purposes while the accounts were subject to a substantial risk of forfeiture. On the other hand, the IRS ruled that once the memorandum accounts were no longer subject to a substantial risk of forfeiture, C should be treated as the owner of the accounts because C had received the economic benefit of the accounts.[265]

In conclusion, the IRS stated that the ruling expressed no opinion on the possible application of Sections 457(f) and 402(b) of the Code to the proposed transaction. However, it should be noted that Section 457(f) only applies to individual participants and beneficiaries,[266] and therefore, Section 457(f) would not apply where a corporation is the beneficiary of the plan. Thus, it appears that Section 457(f) would not be applicable to the proposed transaction. Section 402(b) only applies to a trust established by an employer for the benefit of *its* employees, and therefore, the trust established by H for the benefit of C would not qualify as an "employee's trust" under Code Section 402(b).[267] Finally, the IRS stated that the ruling expresses no opinion on whether the trust would be subject to the requirements of Titles I and IV of the Employee Retirement Income Security Act of 1974 ("ERISA"). As the proposed trust was not established by H for the benefit of its employees, it is highly unlikely that the trust would be subject to the fiduciary and reporting requirements of ERISA.

Although the facts of PLR 9810005 are unique, the tax principles set forth in the ruling should be broad enough to extend beyond the facts of ruling. Consequently, in those industries where close relationships between taxable and tax exempt entities are common, the three party deferral arrangement illustrated in PLR 9810005 may provide tax advantages to both the taxable employer and its employees, and may also provide those employees with a greater degree of security with respect to their benefits than is currently provided by most other types of nonqualified deferred compensation arrangements.

VI. Third-Party Options

Tax exempt organizations have attempted to avoid both the deferral limitations imposed on eligible deferred compensation under Sections 457(a) through (e) of the Code and the substantial risk of forfeiture conditions on Code Section 457(f) plans by converting deferred compensation into third party options. A third party option is an option issued by an employer to an employee which would allow the employee to acquire securities or property other than

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265 The IRS cited Rev. Rul. 83-25, 1983-1 C.B. 116, as authority for this conclusion. In Rev. Rul. 83-25, the IRS ruled that a minor who was the recipient of a damage award which was contributed to a trust pursuant to a court order would be treated as the grantor of the trust because the minor owned the damage award transferred to the trust under the economic benefit doctrine.

266 See Code §§ 457(f)(1)(B), 457(e)(3) & 457(e)(4).

267 See Code § 402(b)(1). Moreover, Code § 402(b)(3) specifically provides that an "employee's trust" is not subject to the grantor trust rules. Consequently, the IRS' classification of the trust as a grantor trust effectively precludes the application of Code § 402(b).

employer stock (e.g., mutual fund shares). Section 457(f)(2)(C) of the Code provides that Section 457(f) does not apply to any portion of any plan that consists of a transfer of property described in Section 83 of the Code. Since options are considered property taxable under Section 83 of the Code, the grant of a third party option should not be subject to the deferral limitations under Code Section 457.

Third party option arrangements were typically structured to provide employees of tax exempt employers with deeply discounted options. The amount of the discount typically reflects the amount of compensation the employee elects to defer. For instance, if an employee wanted to defer $7,500, the employer would reduce the employee's future compensation by $7,500 and issue an option to acquire $10,000 worth of non-employer stock, mutual fund shares or other property (valued as of the date of grant) for an aggregate exercise price of $2,500. These arrangements provided considerable flexibility for the parties to determine the terms and conditions of the option including exercise price, vesting, the period during which the option may be exercised and the effect that certain events (such as termination of employment, death or retirement) may have on the such exercise period.

In theory, third party options were to be taxable under Section 83 of the Code at the time the option was exercised. At that time the employee would recognize ordinary income in an amount equal to the excess of the fair market value of the underlying property or securities subject to the option over the exercise price. In most instances, the employee would be expected to exercise the option and simultaneously sell the underlying property or security, in which case there should be no capital gain or loss upon sale of the property or security. If, however, the employee holds the property or security after exercise, the employee would recognize capital gain or loss upon the subsequent sale of the property or security. The employee's basis in the property or security would equal the sum of the exercise price paid upon exercise of the option plus the amount included in the employee's income on exercise of the option. The employee's holding period would be measured from the date of exercise of the option.

Final Treasury regulations promulgated in 2003 effectively ended the viability of using discounted third party options to avoid the restrictions imposed on eligible deferred compensation under Sections 457(a) through (e) of the Code and the substantial risk of forfeiture conditions under Code Section 457(f) plans. Treasury Regulation Section 1.457-11(d) provides rules for determining whether there is a transfer of property subject to Section 83 or a deferral of compensation taxable under Section 457(f). Under these rules, Section 457(f) will apply (Code Section 83 will not apply) if the date on which there is no substantial risk of forfeiture with respect to compensation deferred under an arrangement that is not an eligible deferred compensation plan, precedes the date on which there is a transfer of property to which Section 83 applies. Thus, if the transfer of the property by a tax exempt or governmental employer occurs on before the substantial risk of forfeiture lapses, Section 83 will apply to the transfer of the property. Conversely, if a tax-exempt or governmental employer promises to transfer property in the future, such promise will be taxable under Section 457(f) if the substantial risk of forfeiture lapses before the property has been transferred. As applied to third party options, the regulations provide, by way of an example, that an option that has no readily ascertainable fair market value within the meaning of Code Section 83(e)(3) on the date of grant[268] is not considered property subject to Code Section 83.[269] This regulation is effective with respect to the transfer of any option without a readily ascertainable fair market value granted after May 8, 2002. The regulation does not apply to options granted on or before May 8, 2002.[270]

Note that this Treasury regulation applies solely to options transferred or granted by a tax exempt or governmental entity. It does not apply to third party options granted by taxable entities. However, the enactment of the AJCA effectively precludes the use of discounted third party options by taxable entities. The Conference Report on the AJCA provides that the new restrictions on nonqualified deferred compensation imposed under Code Section 409A are intended to apply to discounted options.[271] Accordingly, the grant of discounted third party options would subject the recipient of the options to acceleration of tax as well as penalties and interest under Code Section 409A(a)(1).[272]

VII. ERISA REGULATION OF NONQUALIFIED DEFERRED COMPENSATION

Title I of ERISA generally regulates all employee benefit plans including pension plans.[273] Under ERISA, a "pension plan" is

> any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer . . . to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program - (i) provides retirement income to employees, or (ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond, regardless of the methods of calculating the contributions made to the plan, the method of

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268 Code Section 83(e)(3) provides that Section 83 of the Code does not apply to the transfer of an option without a readily ascertainable value. An option does not have readily ascertainable fair market value within the meaning of Section Code 83(e)(3) unless (i) the option is actively traded on an established securities market or (ii) the option is transferable by the optionee, the option is immediately exercisable in full and the option or property subject to the option is not subject to any restriction (other than a lien or restriction to enforce payment of the option price) which has a significant effect on the fair market value of the option. Treas. Reg. § 1.83-7(b).

269 Treas. Reg. § 1.457-11(d)(2)(Example 3).

270 Treas. Reg. § 1.457-12(d).

271 H.R. Conf. Rep. 108-755 at 524.

272 See Section I.C.3 above.

273 Courts have generally found that an agreement with one individual may constitute an employee benefit plan regulated by ERISA. See e.g., Williams v. Wright, 927 F.2d 1540 (11th Cir. 1991).

> calculating the benefits under the plan or the method of distributing benefits from the plan.[274]

Thus, on its face ERISA would appear to regulate any deferred compensation plan (tax qualified or nonqualified) as a pension plan, unless the deferral period under the plan was not until termination of employment, retirement, or beyond. Therefore, unless otherwise exempted, a nonqualified deferred compensation plan would be subject to ERISA's reporting and disclosure rules (ERISA, Title I, Subtitle B, Part 1); its participation, coverage and other substantive rules (ERISA, Title I, Subtitle B, Part 2); its funding rules (ERISA, Title I, Subtitle B, Part 3 and Title IV); its fiduciary responsibility and required trust and other structural rules (ERISA, Title I, Subtitle B, Part 4); and its enforcement rules (ERISA, Title I, Subtitle B, Part 5).

There are two exceptions to these requirements of ERISA. An unfunded excess benefit plan is exempt from all of ERISA Title I and Title IV. ERISA §§ 3(36), 4(b)(5), 201(7), 301(a)(9), 4021(b)(8). An unfunded plan maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees (a "top-hat plan") is also exempted from ERISA's participation, coverage and similar substantive rules (ERISA § 201(2)), funding rules (ERISA §§ 301(a)(3), 4021(b)(6)), fiduciary responsibility and structural rules (ERISA § 401(a)(1)), and, arguably, ERISA's enforcement rules. A top-hat plan is technically subject to ERISA's reporting and disclosure rules but regulations promulgated by the U.S. Department of Labor (the "DOL") provide for abbreviated reporting and disclosure requirements.[275]

Accordingly, any nonqualified deferred compensation plan which can be expected to defer compensation to termination of employment or beyond and which is intended to be exempted from the ERISA requirements must be either an unfunded excess benefit plan or a top-hat plan. Other deferred compensation plans are permissible and not regulated by ERISA if the deferral period under any such plan is not to termination of employment, retirement, or beyond either by its terms or in operation. If a plan does not fit within these exemptions, ERISA's mandatory funding rules require that contributions be made, held in trust for the exclusive benefit of the employees, and vest over prescribed periods of time. ERISA §§ 403, 203. Under the economic benefit principle, once an employee's benefit is set aside in trust for his exclusive benefit and no longer subject to a substantial risk of forfeiture, the employee's benefit is immediately taxable to the employee despite the fact that the receipt of the compensation is deferred until some later period of time. A discussion of the economic benefit principle is provided in Section III, above. An excess benefit plan or a top-hat plan must be "unfunded" to be exempt from ERISA.

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[274] ERISA § 3(2)(A).

[275] ERISA § 110; DOL Reg. § 2530.104-23.

A. Excess Benefit Plan

For a nonqualified retirement plan to be an excess benefit plan, it must be maintained by the employer solely for the purpose of providing benefits in excess of the limitations of Section 415 of the Code (the "415 limits"). ERISA § 3(36). A plan is an excess benefit plan only if it provides benefits that the employee would be entitled to receive from a tax qualified plan but for the 415 limits. Therefore, benefits provided under a plan intended to be an excess benefit plan must be carefully limited so as not to destroy its status as an excess benefit plan. Otherwise, the plan could only qualify for an ERISA exemption if it is a top-hat plan. Excess benefit plans can, in many instances, cover more employees than a top-hat plan. Therefore the top-hat plan exclusion may be insufficient to permit benefits that could be provided under an excess benefit plan.

B. Top-Hat Plan

A plan that provides benefits at the termination of employment or later (and is not an excess benefit plan) is subject to ERISA Title I (and ERISA Title IV if the plan was at any time tax qualified) unless it is an unfunded plan maintained primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees (a "top-hat plan" as described above).[276] The key issue in determining whether a given arrangement qualifies as a "top-hat" plan is whether the covered individuals constitute "a select group of management or highly compensated employees."

The DOL has issued several Opinion Letters (dating from 1975 to 1985) on the subject of what is a "select group of management or highly compensated employees" under ERISA Section 201(2), which are summarized as follows:

Plans Satisfying the Top-Hat Plan Exception

- Plan covering 22 officers out of 68 and officers and employees of a labor union, Gallione v. Flaherty, 70 F.3d 724 (2d Cir. 1995).

- Plan for key employees; salaries exceeded $18,000; exempt from FLSA as administrative, supervisory or professional employees. DOL Op. Ltr. 75-63 (July 22, 1975).

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[276] The DOL has stated that it is the DOL's position that the term "primarily" as used in "maintained primarily for the purposes of providing deferred compensation for a select group of management or highly compensated employees," refers to the purpose of the plan and its benefits and not to the composition of the participants in the plan. See DOL Op. Ltr. 90-14A (May 8, 1990). Thus, according to the DOL, a plan covering any individuals other than "a select group of management or highly compensated employees" would not qualify as a top-hat plan. Id. The Second Circuit recently rejected the DOL's position in Demery v. Extebank Deferred Compensation Plan (B), 216 F.3d 284, 89 (2d Cir. 2000). In this case, which is discussed in more detail below, the court found that a top-hat plan would not lose its status as a top-hat plan merely because a small number of plan participants do not qualify as part of a "select group of management or highly compensated employees."

- Key executives and managers eligible; only 4% of active employees covered; covered employees' salaries averaged 50% more than other management employees. DOL Op. Ltr. 75-64 (Aug. 1, 1975).

- Only 23 of 14,000 employees covered; salaries ranged from $19,200 to $67,900. DOL Op. Ltr. 75-48 (Dec. 23, 1975).

<u>Plans Not Satisfying the Top-Hat Plan Exception</u>

- All supervisory, executive staff department heads and employees with 3 years service eligible. DOL Op. Ltr. 76-100 (Nov. 15, 1976); DOL Op. Ltr. 76-118 (Nov. 15, 1976).

- "Executive payroll" plan covered managerial personnel including department foreman, factory superintendents and officers. Out of 40 participants, 6 were officers or directors (average salary equaled $37,917), 33 represented a broad range of "managerial personnel" (average salary equaled $18,584). DOL Op. Ltr. 85-37A (Oct. 25, 1985).

The DOL, in making these determinations, considered facts such as (1) the percentage of key employees to the total number of employees in the workforce; (2) the comparative salaries (or salary averages) between key employees and non-covered employees; and (3) the job descriptions of the key employees (are they really a "select" group).

There are no regulations on this issue.

The preamble to the proposed regulations defining "highly compensated employees" under Section 414(q) of the Code indicates that the definition of "highly compensated employees" under Section 414(q) of the Code is not to be assumed to be the same as under ERISA's top-hat plan definition. <u>See</u> Relationship to Title I of ERISA, EE-129-86, T.D. 8173. The preamble to the proposed Section 414(q) regulations states that the "Departments of Treasury and Labor concur in the view that a broad extension of [S]ection 414(q) [of the Code] to determinations under [S]ections 201(2), 301(a)(3), and 401(a)(1) of ERISA would be inconsistent with the tax and retirement policy objectives of encouraging employers to maintain tax-qualified plans that provide meaningful benefits to rank-and-file employees". <u>Id</u>.

The legislative history of ERISA is consistent with the position taken in the regulations. ERISA was designed as a remedial statute intended to protect the rights of employees who could not protect their own rights. Legislative History of the Employee Retirement Income Security Act of 1974, Public Law 93-406, prepared by the Subcommittee on Labor of the Committee on Labor and Public Welfare, United States Senate, 94th Cong., 2d Sess. 604, 3295. Congress only intended to permit limited exemptions from the ERISA requirements. <u>Id</u>. These exemptions are, generally, limited to government plans, church plans, workers' compensation plans, nonresident alien plans, plans to which no employer contributions can be made, excess benefit plans, and top-hat plans.

Although the legislative history of ERISA does not define what is intended by the phrase "a select group of management or highly compensated employees", it is clear that the intent of Congress was to limit the definition. The example used in the legislative history to describe a top-hat plan concerns a "phantom stock" or "shadow stock" plan established solely for the officers of the corporation. Id. at 4563. These examples suggest that the phrase "a select group of management or highly compensated employees" should be read very narrowly.

In addition, the legislative history explains that plans to which no employer contributions can be made were exempted from the ERISA vesting requirement, "[s]ince these plans are, in effect, controlled by the employees for whose benefit they are established [and, therefore,] there is no need to impose the vesting requirements of [ERISA on these plans]." Id. at 3333. The definition of "a select group of management or highly compensated employees" is meant to be similarly limited by including only those employees who have sufficient individual bargaining power to insure that their rights to benefits under an unfunded nonqualified deferred compensation plan are adequately protected. See DOL Op. Ltr. 90-14A (May 8, 1991). Based on this definition, the definition of highly compensated employees in Section 414(q) of the Code could (depending on the facts and circumstances) be overly broad.

By definition, highly compensated employees under Section 414(q) of the Code can include the highest paid 20% of the employees of an employer.[277] If an employer has a large number of employees, it is highly unlikely that the entire top 20% group would be in a position to have sufficient individual bargaining power with respect to their benefits under a plan of deferred compensation. Therefore, the definition of highly compensated employee (Section 414(q) of the Code) could be broader than the ERISA definition of a select group of management or highly compensated employees. Accordingly, if the definition of a select group of management or highly compensated employees is limited to the persons (or person) who have sufficient individual bargaining power, an employer could be quite limited with respect to the group it could cover in a top-hat plan.

In a recent decision that may help delineate the limit on what portion of an employer's workforce may participate in a top-hat plan, the Second Circuit recently upheld the top-hat status of a deferred compensation plan that covered approximately 15% of the employer's workforce. The plan at issue in Demery v. Extebank Deferred Compensation Plan (B),[278] the Extebank Deferred Compensation Plan (B) ("Plan B"), was offered by Extebank to assistant vice-presidents, managers, and other senior officers, representing approximately 15% of Extebank's workforce. Shortly before and following Extebank's merger with another bank, all of the

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277 The Small Business Job Protection Act of 1996, Pub. L. No. 104-188, amended the definition of highly compensated employee under Code Section 414(q). As amended, any employee with compensation in excess of $80,000 in the prior plan year (adjusted for inflation) will be highly compensated. The compensation limit was increased to $85,000 effective for compensation paid in 2001 (for purposes of determining highly compensated employees in 2002). The plan may limit highly compensated employee status to the highest 20% of the employer's employees.

278 216 F.3d 284 (2d Cir. 2000).

plaintiff executives terminated from Extebank and received certain benefits under Plan B. The executives then filed a complaint claiming benefits under ERISA, which the defendants moved to dismiss on the basis that Plan B was a top-hat plan exempt from the substantive requirements of ERISA.[279]

On the issue of whether Plan B was maintained primarily for a select group of management or highly compensated employees, the court noted that Plan B was supplemental to the bank's regular pension plan and established "as a means to retain valuable employees." Further, Plan B was offered to selected officers of the bank, in management positions, and highly compensated.[280] The plaintiffs argued that the "select group" requirement was not met because participation was offered to over 15% of employees, the participants were not all either management or highly compensated, and the participants did not have the ability to negotiate for themselves. In response, the court found that, while the number of employees Plan B was offered to was at or near the upper limit of the acceptable size for "select group," the number alone did not make Plan B too broad to be a top-hat plan. The court found Plan B participants were limited to highly valued managerial employees and that participation was not offered to employees at widely varying levels.[281]

Next, the court found it significant that ERISA defines a top-hat plan as "primarily" designed to provide deferred compensation for certain individuals, suggesting a plan would not be disqualified from top-hat status because a small number of participants did not meet the criteria of management or highly compensated employee. Therefore, the plaintiffs' focus on the two or three employees participating who were arguably not highly compensated or a select group of management was not dispositive.[282]

Finally, the court found that while an ability to negotiate was an important component of top-hat plans because, in exempting top-hat plans from ERISA's substantive requirements, Congress "deemed top-level management, unlike most employees, to be capable of protecting their own pension expectations," the record was silent on the plaintiffs' ability to negotiate the terms of Plan B.[283] The court found that the plaintiffs did not provide sufficient evidence to raise a question of fact on this issue. Finding the plaintiffs' claims without merit, the court concluded that Plan B was a deferred compensation plan maintained primarily for a select group of management or highly compensated employees and, therefore, was a top-hat plan.[284]

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279 Id. at 285.

280 Id. at 287-88.

281 Id. at 288.

282 Id. at 289.

283 Id. (citing Gallione v. Flaherty, 70 F.3d 724, 727 (2d Cir. 1995)).

284 Id. at 290.

While Demery may provide some comfort to employers that maintain somewhat broad-based nonqualified deferred compensation plans, employers should remain cautious in designing such plans to ensure that the participation remains limited to a select group of management or highly compensated employees. While the holding in Demery was generally favorable, it should be emphasized that the court described 15% participation as at or near the upper limit for acceptable size. Moreover, while it may appear at first blush that the court dismissed as a factor the ability of the participants to negotiate their compensation packages, it is clear that the court merely found that the plaintiffs failed to present sufficient evidence to support a finding that they lacked the ability to negotiate. Perhaps the most important aspect of this case, however, is the court's flexible position on participation by a small number of employees who may not qualify as members of a "select group of management or highly compensated employees". This holding should effectively shift the focus of the analysis from an employee-by-employee determination to an analysis of the group of participants as a whole. Of course, if the plan benefits a group of employees that includes a significant number employees who do not meet the managerial or highly compensated status, a court may conclude that the plan does not meet the top-hat requirements because it is no longer maintained "primarily" to provide deferred compensation to a select group.