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Code Section 409A and the Hidden Deferred Compensation in Executive Employment Agreements

New Section 409A of the Internal Revenue Code governs deferred compensation in a nonqualified plan of deferred compensation. This article discusses how to identify deferred compensation in your employment contracts and executive compensation agreements, and how to restructure these agreements so that they either avoid section 409A altogether or conform with it.

New Section 409A of the Internal Revenue Code was enacted as part of the American Jobs Creation Act o f 2004, Public Law 108-357. Section 409A creates strict new rules governing compensation deferred under a nonqualified deferred compensation plan, effective January 1, 2005. The key points of Section 409A have been discussed in an earlier *Benefits Law Journal* article.[1] This article focuses narrowly on the implications of section 409A for the often hidden deferred compensation in executive employment and pay agreements. Because of these implications, section 409A will force restructuring of many common arrangements such as multi-year employment contracts, garden-variety reimbursement agreements (such as for club dues, relocation expenses, and financial planning services), parachutes, and indemnification agreements.

This article first summarizes the key provisions of section 409A. It then discusses in some detail the novel definition of "deferred compensation" for section 409A purposes set forth in Treasury Guidance under Notice 2005-1.[2] It applies this definition in a practical way to help you spot deferred compensation in a wide variety of executive contracts and compensation agreements. It concludes by walking through ways in which agreements might be drafted to avoid section 409A altogether, and, if not to avoid it, then to comply with it.

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Background: Section 409A

Section 409A imposes new rules on elections and payouts under a nonqualified deferred compensation plan. Under the new rules, an election to defer pay must generally be made before the year in which related services are rendered.[3] A deferral election is permitted after services have commenced only under narrowly defined circumstances.[4] The plan must specify that compensation under the plan may be paid only upon a specified date, or according to a specified schedule, or upon the occurrence of events enumerated by statute, namely, death, disability, or separation from service (six months after separation for a key employee), a change in ownership or control, to the extent permitted by Treasury regulations; or the occurrence of an "unforeseeable emergency."[5] Payment of deferred compensation may not be accelerated.[6] Treasury guidance clarifies that Section 409A governs a plan of deferred compensation paid by any "service recipient" to any "service provider."[7] For convenience we denote these as "employer" and "employee" respectively, but it should be understood that a service provider can include a partner providing services to a partnership, an independent contractor, or a non-employee director of a corporation.[8]

If a plan fails section 409A in writing or operation, compensation deferred under the plan is subject to immediate taxation, plus interest since the vesting date, plus an additional 20% tax.[9].

In its new definition of "plan" for section 409A purposes, Treasury guidance amplifies the penalty risk of failure. Notice 2005-1 first divides the world of deferred compensation plans into "account balance" plans, "nonaccount" balance plans, and plans which are neither — typically, equity compensation plans such as stock option plans.[10] The terms "account balance" and "nonaccount balance" plans have the same meanings as in regulations under Code section 3121(v)(2) (governing the treatment of deferred "wages" for payroll tax purposes), and generally denote defined contribution-type and defined benefit-type plans, respectively. For penalty purposes, Notice 2005-1 provides that a single plan comprises all the arrangements of the same type — for example, all account balance plans — covering the same individual.[11]

Having provided a novel individual-by-individual plan aggregation rule, Notice 2005-1 does not clarify how it might mesh with other possible aggregation rules under Section 409A. The statute provides that if a nonqualified deferred compensation plan fails section 409A, penalties shall apply only to participants "with respect to whom the failure relates."[12] Legislative history, however, suggests that the imputation of failure might be spread rather broadly to all similarly situated participants. For example, if payment under a SERP is impermissibly accelerated for one SERP participant, while not entirely clear, legislative history suggests that the failure might relate to all SERP participants, even those who did not actually receive an impermissibly accelerated distribution.[13] Notice 2005-1, however, does not address this other possible aggregation rule, nor how it interacts with the individual-by-individual aggregation rule.

The individual-by-individual aggregation rule means that strict compliance with section 409A is critical for even the insignificant deferred compensation promises hidden in your executive employment agreements. Consider for example an agreement to reimburse executives' tax preparation fees up to $3,000 per year. If structured as a deferred compensation plan subject to 409A — which without amendment it probably is, as we discuss below— it is a nonaccount-balance nonqualified deferred compensation plan. Any failure triggers tax and penalties under section 409A, not only for the $3,000 reimbursement agreement, but for all other nonaccount balance plans covering the same individual, including other reimbursement agreements, and most significantly his or her SERP and other nonqualified "wraparound" defined benefit plans.

A New Definition of Deferred Compensation

Section 409A applies in addition to the pre-existing rules governing deferred compensation for income tax purposes under the Internal Revenue Code. Section 409A(c) states that "nothing in this section shall be construed to prevent the inclusion of gross income under any other provisions of this statute or any other rule of law earlier than the time provided by this section."

For purposes other than Code section 409A, deferred compensation for income tax purposes has very generally been understood to be any compensation that is taxable to the service provider in a year after the year it would be taxable to him or her under an accrual basis method of accounting, generally in a year after the year that the taxpayer has rendered all services necessary to entitle him or her to the compensation. For cash basis taxpayers, various Code provisions and non-Code doctrines govern the year in which compensation is first included in income. For example, income becomes taxable to the taxpayer when it is first actually or constructively received by him or her; [14] is funded or otherwise confers an "economic benefit" on him or her;[15] is treated as pledge, collateral or note or otherwise as the "equivalent of cash";[16] or is assigned by the taxpayer to a third party.[17] These doctrines, however, are rules of income inclusion. They define only the moment when deferral ceases to be effective for tax purposes; they do not define what deferred compensation is. Even the IRS itself is a little vague, for example defining "deferred compensation" as an "elective or nonelective plan, agreement, method, or arrangement … to pay the employee compensation some time in the future."[18]

In the absence of a pre-existing definition for income tax purposes, to regulate "deferred compensation" Section 409A accordingly must first define it. This definition is not supplied by the statute. Section 409A(d) states that a nonqualified deferred compensation plan is a plan that provides for the "deferral of compensation." The only statutory exceptions are any qualified employer plan (generally, any broad-based tax-favored retirement income-type plan, such as those qualified under Code section 401(a) and 403(b)), and any "bona fide vacation leave, sick leave, compensatory time disability pay or death benefit plan." Also, the statute implies, without so stating, that "deferred compensation" does not include compensation that is excludable from income by statute, such as excludable fringe benefits under section 132(a).

Notice 2005-1 fills the gap with a two-prong definition of deferred compensation, which is in part based on the regulatory definition of deferred compensation for purposes of "wages" under section 3121(v)(2), and in part new.

The first prong defines "deferred compensation" as any compensation payable to an employee in a year after the year in which he or she has a "legally binding right" to it (and for which the employee is not in actual or constructive receipt when the legally binding right arises).[19] The term "legally binding right," is not precisely defined, but is evidently broad. An employee has a "legally binding right" to compensation even if the right is contingent on events that have not yet occurred, and may never occur, and even if the compensation is subject to future service conditions or otherwise subject to forfeiture. Notice 2005-1 states that the that an employee does not have a "legally binding right" to compensation if the compensation can be unilaterally reduced at the discretion of the employer or other person after related services have been performed.[20] Nonetheless, the employer's unilateral discretion will not forestall the creation of a "legally binding right" if the discretion is unlikely to be exercised, or is exercisable only upon the occurrence of an unlikely event.

In its discussion of employer discretion, Notice 2005-1 implies that a promise may confer a "legally binding right" for section 409A purposes, even if the promise is not legally enforceable. For example, ERISA-governed severance pay plans typically make payments of benefits entirely dependent on the discretion of the employer, and are subject to cancellation at any time at the employer's discretion, even after occurrence of the participant's severance of employment. The Federal courts have held that these promises, while good ERISA plans, are not enforceable promises, for the reason that on their face they are within the employer's sole discretion. While these promises are not enforceable under ERISA or state law (which is preempted), Notice 2005-1 implies that they may create a good "legally binding right" for section 409A purposes, if the employer does not typically exercise its discretion to refuse payment.

There is at this point some very slight question as to whether a contingent promise to pay creates a "legally binding right" in cases where the contingency is not within control of the employee. By contrast, for contingencies within the employee's control, it is clear that the legally binding right will arise when the promise is made, even before the contingency has arisen. For example, in the case of agreements to reimburse personal-type expenses such as tax preparation fees, club dues, newspapers, etc., the contingency that triggers the reimbursement is entirely within the employee's control, and the legally binding right arises when the promise is paid.[21] But for contingencies not within the employee's control, such as involuntary severance payments, and indemnification agreements, there is still some question about whether Treasury might still decide that the legally binding right does not arise until the contingency event occurs.[22] While this question is still modestly up in the air, present indications are that all contingent promises create a "legally binding right" for section 409A purposes, including those based on contingencies not within the employee's control. For all contingent promises, then, the only relevant question about the effect of a contingency for section 409A purposes is whether it creates a "substantial risk of forfeiture" — a concept discussed immediately below. The remainder of this article is based on this analysis, and presupposed that a legally binding right is created for section 409A purposes by all contingent promises.

The second prong of Treasury's definition of "deferred compensation" is a key limitation on the first. An amount is not deferred compensation if it is required by agreement to be paid no later than 2 ½ months after the taxable year in which it is no longer subject to a substantial risk of forfeiture.[23] For this purpose, the taxable year of vesting is the *later* of the employer's taxable year, or the employee's taxable year.[24] Notice 2005-1 further states that if there is no cognizable vesting condition under section 409A, the 2 ½ month rule is applied to the taxable year in which the employee's legally binding right first arises.

The 2 ½ month rule effectively makes the definition of deferred compensation under section 409A turn on the vesting date. If a legally binding right to compensation arises in Year 1, but the compensation is scheduled to vest for section 409A purposes in Year 4, and is required by the terms of the agreement to be paid within the first 2 ½ months of Year 5, the promised compensation is not "deferred compensation" for section 409A purposes.

Because of the 2 ½ month rule and the consequent importance of identifying the vesting date, the definition of "substantial risk of forfeiture" is key. Notice 2005-1 states that compensation is subject to a substantial risk of forfeiture if payment is conditioned on (1) the performance of "substantial future services" or (2) the occurrence of a condition "related to the compensation."[25] For these purposes, Notice 2005-1 states that the performance of substantial future services does not include the refraining from rendering services, such as a noncompete agreement. A condition “related to the compensation” must be related either to the employee’s performance of services for the employer, or the employer’s “business activities or organizational goals,” for example, “the attainment of a prescribed level of earnings equity value or liquidity event.” The risk of forfeiture must be substantial. From similar language in regulations under Code section 83, it can be inferred that a promise to pay future compensation conditioned on the employee’s not being fired “for cause” does not give rise to a substantial risk of forfeiture for purposes of section 409A.[26]

While the definition of “substantial risk of forfeiture” under section 409A as set forth by Notice 2005-1 may seem similar to that under section 83 (governing compensatory transfers of property), the section 409A definition is different, and typically gives rise to vesting earlier than does section 83. Return to our earlier example of the employer’s promise to reimburse the employee for tax preparation fees. Under section 83 , the promised reimbursement is arguably not vested until the reimbursable service — the tax return preparation — is provided. [27] For section 409A purposes, by contrast, the employee is vested in the promised reimbursement as soon as he or she has performed the services necessary to be entitled to claim it — even before any tax return preparation services have been provided for him or her, and even if no tax return preparation services are ever provided. As a second example, consider the effects of a noncompete agreement. For section 83 purposes, a noncompete agreement can under some circumstances give rise to a substantial risk of forfeiture.[28] Under section 409A, by contrast, Notice 2005-1 implies that a noncompete agreement can never give rise to a substantial risk of forfeiture and can under no circumstances delay vesting.

Having set forth the framework for defining “deferred compensation,” Notice 2005-1 sets forth some key exceptions. For equity based arrangements, the exceptions include incentive stock options and other options qualified under Code section 423. Nonqualified stock options are also excepted from the category of section 409A-covered deferred compensation if the option is not in-the-money (the exercise price is not less than the fair market value of the stock) on the date of grant; the receipt, transfer or exercise of the option is taxable under section 83 of the Code; and the option does not include additional deferral features (for example, the option cannot be settled by a promise of cash or stock payable in the future). Restricted stock is excluded from the definition, except for a promise to deliver such property in the future. Stock-settled stock appreciation rights (SARs) are excluded from section 409A if the SAR exercise price is not less than the fair market value of the stock on the date of grant, the stock subject to the right is publicly traded, and the SAR contains no additional deferral features.[29]

Practical Implications

To identify deferred compensation lurking in employment agreements, here is how to apply the foregoing rules in practice.

First, identify the vesting condition. This is the last act or event that entitles the executive to receive the compensation. Second, apply the 2 ½ month rule. If compensation under the agreement is not expressly scheduled to be paid within 2 ½ months after the taxable year it vests, it is deferred compensation under section 409A. While similar in some respects to the vesting date under section 83, the vesting date under section 409A may well be earlier, because a forfeiture condition that may forestall vesting under section 83 does not necessarily forestall vesting under section 409A. Vesting conditions that must be ignored for Section 409A purposes include fired-for-cause clauses (also ignored under section 83), noncompete agreements, and any contingencies other than the ones specified in Notice 2005-1 (i.e., except those directly related to the employee's performance of service and the employer's business condition). If there is no vesting condition, at least no vesting condition that is cognizable under Notice 200-1, the 2 ½ month rule applies to the taxable year in which the legally binding agreement is made.

Applying this analysis to specific kinds of employment agreements, here is a partial list of the agreements that should be scrutinized closely for compliance with Section 409A.

<u>Employment contracts unless fired "for cause" or quits without "good reason</u>." Employment contracts typically guarantee pay over a period of years unless the executive is fired "for cause" or quits without "good reason." We have noted above that a "fired for cause" clause does not create a substantial risk of forfeiture for section 409A purposes, and does not prevent immediate vesting of the promised pay. In addition, there is reason to believe that a "quits without good reason" forfeiture clause similarly does *not* raise a substantial risk of forfeiture in most cases. Accordingly, the vesting condition (not quitting without good reason) might have to be ignored, and the agreement might *vest in the taxable year when made.* In this case, virtually all amounts under the contract will be payable after the 2 ½ month window, and will be subject to section 409A at the outset. Accordingly, all payments under the agreement must be drafted to comply with the fixed-date payout rule, the 6-month-delay rule for key employees, and so forth.

<u>Severance pay conditioned on signing a release.</u> Employment agreements typically specify that the executive will not receive any amounts payable after termination of employment, unless at the time of his or her future employment termination, he or she first signs a release of claims. One possible analysis of these release clauses is that the executive has no "legally binding right" to

severance payments until he or she accepts the employer's offer by signing the release. Under this possible analysis, until the agreement is signed, no legally binding right, no deferred compensation (assuming a lump sum payment within 2 1/2months), no problem.

Under Notice 2005-1, however, the better answer is probably that the employment agreement creates the "legally binding right," albeit a contingent one, to severance payments. The release contingency must therefore be analyzed as a possible vesting condition. As we have seen, the release is probably not a cognizable vesting condition under section 409A, because it relates neither to the employee's performance of services, nor to the employer's "business activities or organizational goals." Accordingly, under this more likely reading, the 2 ½ month rule applies to the severance payments in the year the agreement is made. All severance payments are "deferred compensation" for section 409A purposes, and must be drafted accordingly.

Performance pay. For performance-based pay, the vesting event is generally the satisfaction of the performance condition, because the performance condition is a "condition related to the purpose of the compensation," and apparently satisfies the narrow definition under Notice 2005-1 of this term — that is, a condition related to the employee's "performance" for the employer, or the employer's "business activities or organizational goals." Thus, performance-based pay and bonuses are generally not subject to section 409A if required to be paid within 2 ½ months of the taxable year the performance condition is met. If the 2 ½ month rule is not met, however, they will generally be deferred compensation subject to section 409A. Treasury staff has informally indicated that the performance condition is met in the year all the conditions are in fact satisfied (for example, the year the profit target is in fact made), even if the analysis to determine whether the conditions are satisfied is not performed or performable until a later year.[30] Thus, if a bonus is based on profits as of December 31, 2005, which are not determined until March 31, 2006, and the bonus is immediately paid on April 1, 2006, the bonus is "deferred compensation" under section 409A.[31]

Expense reimbursements. Employment agreements typically promise to reimburse the executive for a variety of expenses, such as club dues, tax return preparation fees, financial planning fees, and relocation expenses. Some are employment-related fringe benefits that are nontaxable under Code section 132(a). While not entirely clear, section 132(a)-excludable fringes are probably not subject section 409A. But others are taxable, such as reimbursements of tax return preparation and financial planning fees. If payable more than 2 ½ months after the year in which the vesting event occurs, these are deferred compensation under section 409A. As we have noted, Notice 2005-1 implies that the vesting event is *not* the occurrence of the reimbursable event. Rather, the reimbursement agreement vests earlier — either when the executive performs the services necessary to qualify him or her for the reimbursement perk, or when the employment contract is signed. For example, virtually all reimbursements under an agreement to reimburse the specified expenses of a terminated or retired executive will almost certainly be "deferred c compensation" under section 409A.

Indemnification and other contingent payments. Like reimbursements generally, some indemnifications are excludable under section 132(a) (*e.g.*, indemnification for employment-related legal expenses while employed)), and may be excluded from section 409A. But indemnifications are taxable, such as tax indemnification and gross-up agreements, and, possibly, indemnifications for the legal expenses of former employees (where it is not entirely clear that section 132(a) applies). Other contingent pay includes relocation make-whole agreements (*e.g.*, for any loss on sale of a residence). As with all other reimbursements, these contingent payments would appear to vest for section 409A purposes when the employee performs the services that entitle him or her to the perk, and not when the contingency arises. Accordingly, these amounts are deferred compensation subject to section 409A if payable more than 2 ½ months after the vesting year — defined as the year of the employee's services, rather than the year of the contingent event.

Parachute payments A special category of contingent payment is the parachute payment, contingent on a change in ownership or control of the employee. When do these amounts vest? Unlike other contingencies, a change in control is arguably a good vesting condition under section 409A, because it is arguably related to the employer's "business activities or organizational goals" as required by Notice 2005-1, Q&A-10. If this is the case, then parachute payments are not deferred compensation if required to be within 2 ½ months of the year in which the change in control occurs, and the payments are not subject to section 409As requirement for acceptable payouts based on a "change in control." Unfortunately, however, many parachute agreements take much longer to work out than the time allotted by the 2 ½ month rule. Accordingly, for many employers, this narrow way of having parachute payments escape section 409A altogether may be of limited utility.

Involuntary Severance Pay. For amounts that are payable solely upon an involuntary termination of employment, can it be argued that involuntary-severance pay would not vest until the termination date? As of this writing, there is no indication that this is the case. Rather, it appears that involuntary terminations will be treated as all other contingencies, even those not within the employer's control. Under this analysis, severance pay conditioned on involuntary termination will be a "legally binding right" when made, and will vest as soon as the employee has performed the service conditions necessary to entitle him or her to the benefit should involuntary termination occur. Under this scenario, severance pay is likely to be deferred compensation under section 409A for most participants in the severance pay plan.

The surprising coverage of grandfathered agreements Section 409A generally provides that amounts earned and vested as of December 31, 2004, are grandfathered, and do not have to meet section 409A. The grandfather may well be unavailable for promises in the typical employment agreement, even if the employment agreement was signed by December 31, 2004.

First, the grandfather covers only amounts that were vested as of December 31, 2004. For promises like reimbursement agreements and contingent payments, it is unclear when vesting occurs.

Second, guaranteed salary that might have *vested* as of December 31, 2004, in many cases is *not grandfathered*. Employment agreements typically promise to pay salary and benefits unless the executive is fired “for cause” or quits without “good reason.” We have noted that these promises may well be vested immediately when the agreement is made. Assuming these promises are vested as of December 31, 2004, for section 409A generally, are they also grandfathered?

Oddly, no. Notice 2005-1 states that, whether or not these amounts are vested as of December 31, 2004, they *are not grandfathered*. When valuing the compensation subject to the grandfather protection, Notice 2005-1 tells you to take the present value, as of December 31, 2004, of the amount guaranteed under the plan if the participant “*voluntarily terminated services without cause*” on December 31, 2004. While worded somewhat differently from the typical agreement, the valuation rule appears to mean that if the participant’s pay guaranteed as of December 31, 2004, would be nonpayable if he or she quit without good reason, then the compensation is not covered by the grandfather.

Accordingly, if pay promised under a pre-2005 employment contract has a “quits without good reason” exception, it is clearly not covered by the grandfather — although it may well be vested.

Drafting Solutions to Some Section 409A Problems

It is possible to draft some promises to fall outside the definition of deferred compensation under section 409A by stating expressly in the agreement that amounts must pay out no later than 2 ½ months after the year in which they vest. This solution is of course limited, as discussed below.

Reimbursement agreements. Some reimbursement agreements can be drafted to fit within the 2 ½ month rule and thus avoid section 409a. As an example, consider a 4-year contract that includes a promise to reimburse financial planning fees. The contract can be redrafted to avoid section 409A by clearly requiring that (1) the executive actually perform services in any one year in order to be eligible to receive the reimbursements (i.e., the vesting condition), and (2) all reimbursement requests be submitted timely, so that all payments be made no later than 2 ½ months after the vesting year.

Other agreements will be harder, such as post-employment agreements. Consider an agreement that promises to reimburse the executive's financial planning fees for five years after termination of employment. Applying the logic of Notice 2005-1, this promise vests, at the very latest, at termination of employment. Viewed this way, every reimbursement is payable more than 2 ½ months after the vesting year, and so is subject to section 409A. It is not clear that it will be possible to draft these payments to fit the fixed-date-or-fixed-schedule payout requirement of section 409A. Until further guidance is issued, the only practical solution may be to draft these agreements as promise of fixed amounts of annual severance pay designed to cover personal expenses, and payable without regard to whether the expenses are incurred or not.

Agreements that are contingent on events not within the employee's control may be impossible to draft under current guidance. For example, consider an indemnification of legal expenses incurred after the employee's termination of service. As a practical matter, this can neither be drafted as a fixed allowance, nor can it be drafted to fit any of the payout events of section 409A. It is to be hoped that further guidance will address this issue.

Springing severance pay. Typically, guaranteed pay will change in timing or amount after termination of employment. For example, a multi-year agreement might promise two years of salary if the executive is fired without cause, payable in a lump sum. Such payments may be viewed as caused by a "separation from service." If the agreement covers a key employee of a publicly traded company, it should be drafted to ensure that the post-separation payment cannot begin until six months after the date of separation.

Modifications and Renegotiations of Employment Contracts. If payments promised under an employment contract are deferred compensation subject to section 409A, then renegotiation of the contract to accelerate promised payments might be a section 409A violation. Also, the stretch-out of any payment might be a second deferral election under section 409A. If you renegotiate or modify the terms of an outstanding agreement, consider whether any change in the payment terms is a prohibited acceleration, or a second deferral election subject to the 5-year rule and other applicable rules.

Changes in the Terms of Outstanding Options and SARs. Options and stock-settled SARs granted "at the money" are generally excluded from the definition of deferred compensation subject to 409A. Even for these options and

SARs, however, it is worth checking whether provisions in employment agreements outside of the option plan or SAR plan could unwittingly cause them to violate section 409A.

For example, it is not unusual for an executive's employment contract to specify that an option exercise period will be extended if he or she terminates employment. If the extension pursuant to the employment contract is granted as a new adjustment, it may be treated as the grant of a "new" option for section 409A purposes. If the "new" option has the inherited strike price of the "old" option, and the price of the underlying stock has risen since grant of the old option, then the "new" option will be considered a grant of an in-the-money option, subject to section 409A. The same result is less likely to follow, of course, if the extension of the exercise period is part of the option plan or grant, rather than added as a later modification.

Change-in-Control Acceleration Provisions. Section 409A provides that a deferred compensation agreement may provide that compensation is payable upon a "change in control" of the employer corporation, subject to Treasury guidance. Notice 2005-1 provides detailed rules governing when a change in control is an acceptable payout event for section 409A purposes.

For many employers, the conditions of Notice 2005-1 probably do not conform to the employer's preferred change-in-control triggers. As a simple example, Notice 2005-1 generally provides that there is a good "change in control" for section 409A-permitted payout purposes if during a 12-month period, 50% of a corporation's board of directors is replaced.[32] Many parachute agreements, by contrast, trigger payouts upon the replacement of a smaller percentage of the corporation's board of directors, say 30% or 20%.

Employers have few good choices here. One option is to require that all payments take place within 2 ½ months of the year in which the change in control occurs. Because the change in control is likely a good vesting condition, this will ensure that the payments escape section 409A altogether by fitting within the 2 ½ month rule

Parachute payments typically take longer to compute than the time allowed by the 2 ½ month rule, however. Thus, most employers may prefer a two-pronged solution. First, they can add a payout provision that is triggered by any change in control that exactly conforms with the narrow specifications of Notice 2005-1. Second, for nonconforming changes in control, they can add a "double trigger" payout provision, providing that payments will be made upon separation from service following the nonconforming change in control. Pending further guidance, it is reasonable to infer that, because these payments are made upon a permissible section 409A payout event (separation from service) they are good section 409A payments, even if coupled with a second condition not recognized as a good section 409A payout event.

Conclusion

Section 409A affects many employment and compensation agreements beyond the purportedly abusive agreements it purports to regulates. Among these are multi-year employment contracts, reimbursement agreements, indemnification agreements, and simple parachute agreements. Pending further guidance by the Treasury Department, this article has outlined a few simple steps to begin analyzing these agreements under section 409A, and undertaking the initial drafting steps necessary to protect them from that section's harsh new penalties.

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[1] "New Sectoin 409A: A Sweeping New Statute Affecting Nonqualified Deferred Compenastion," Tara Silva Maleska, *Benefits Law Journal* Winter 2005

[2] Notice 2005-1, 2005-2 IRB 274 (December 20, 2004).

[3] I.R.C. § 409A(a)(4).

[4] *Id.*

[5] I.R.C. § 409A(a)(2)(A).

[6] I.R.C. § 409A(a)(3)

[7] Notice 2005-1, Q&A-3(a), Q&A-4(a).

[8] Notice 2005-1, Q&A-3(a), Q&A-8.

[9] I.R.C. § 409A(a)(1)(B).

[10] Notice 2005-1, Q&A-9.

[11] Notice 2005-1, Q&A-9.

[12] I.R.C. § 409A(a)(1)(ii).

[13] Conf. Rep. No. 755, 108th Cong. 2d. Sess; *reprinted at Pension & Benefits Law*, Thompson RIA, New York, 2005, at p. 1404, as an example of this rule states:

> For example, suppose a plan covering all executives of an employer (including those subject to section 16(a) of the Securities and Exchange Act of 1934) allows distributions to individuals subject to section 16(a) upon a distribution event that is not permitted under the provision. The individuals subject to section 16(a) rather than all participants of the plan, would be required to include amounts deferred in income and would be subject to interest and the 20-percent additional tax.

[14] Treas. Reg. § 1.451-2(a) ("income is constructively received by the taxpayer in the tax year during which it is credited to his account set apart from him or otherwise made available to him.")

[15] *Sproull v. Commissioner*, 16 T.C. 244 (1951*), aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952). The economic benefit doctrine has largely been supplanted by I.R.C. § 83, which governs the taxation of compensatory "transfers" of "property," including the provision of vested compensation through a funded trust (other than a trust associated with a plan qualified under I.R.C. § 401(a)).

[16] *Cowden v. Commissioner*, 289 F.2d 20 (1961) ("[I]f a promise to pay of a solvent obligor is unconditional and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money, such promise is the equivalent of cash and taxable in like manner as cash would have been taxable had it been received by the taxpayer…")

[17] *Lucas v. Earl*, 281 US 111 (1930); *United States v. Basye*, 410 US 441, 450 (1973). In addition, the Internal Revenue Service has through its administrative practice from time to time suggested that the assignment of income doctrine might trigger current taxation of amounts that the taxpayer "assigns" to himself or herself from some future period (such as the next year) to an even more future period. This doctrine has never been tested in court and it is unclear whether the Service still adheres to it.

[18] Internal Revenue Service Nonqualified Deferred Compensation Audit Techniques Guide (02-2005), ttp://www.irs.gov/businesses/corporations/article/0,,id=134878,00.html

[19] Notice 2005-1, Q&A-4.

[20] *Id*.

[21] *See, e.g.*, remarks of Daniel Hogans, United States Department of the Treasury, Office of Tax Policy, Benefits Tax Counsel, Attorney-Advisor, before the D.C. Bar, Tax Section, Employee Benefits Committee, March 2, 2005; remarks of Daniel Hogans, United States Department of the Treasury, Office of Tax Policy, Benefits Tax Counsel, Attorney-Advisor, Transcript of Tax Management Educational Institute Roundtable, January 24, 2005, *reprinted in BNA Daily Tax Reporter*, Thursday, February 10, 2005.

[22] *See generally*, Transcript of Tax Management Educational Institute Roundtable, January 24, 2005, *reprinted in BNA Daily Tax Reporter*, Thursday, February 10, 2005.

[23] Notice 2005-1, Q&A-4(c). Notice 2005-1.

[24] *Id.*

[25] Notice 2005-1, Q&A-10.

[26] Treas. Reg. § 1.83-3©(2).

[27] Treas. Reg. § 1.83-3©(4), Example 2.

[28] Treas. Reg. § 1.83-3©(2).

[29] Notice 2005-1, Q&A-4(d)

[30] *See, e.g.*, remarks of Stephen B. Tackney, United States Department of the Treasury, Internal Revenue Service Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), Executive Compensation Branch, Attorney, in Transcript of Tax Management Educational Institute Roundtable, January 24, 2005, *reprinted in BNA Daily Tax Reporter*, Thursday, February 10, 2005.

[31] Assuming, of course, a calendar year tax year for both service recipient and service provider.

[32] See Notice 2005-1, Q&A-13(a)(i).